PUBLIC ACCOUNTING and AUDITING

Public Accounting and Auditing

Correlating the subjects, Accounting—Theory and Practice, Auditing—Theory and Practice, and Commercial Law, thereby enabling the student to obtain a view of each of these subjects in its relation to the problems of the Public Accountant and Auditor

By

J. F. SHERWOOD

Certified Public Accountant and Auditor

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PREFACE

Accountancy is generally considered the youngest of the professions. In 1896, New York enacted the first Certified Public Accountant law in this country, and thus formally recognized accountancy as a profession. Since that time, all the states excepting two have enacted similar laws, until accountancy is now recognized as one of the leading professions. Almost imperceptibly accounting and auditing have grown to be indispensable factors in the policy of every business enterprise. Today, it is estimated that there are approximately three thousand Certified Public Accountants in the United States. There are hundreds of firms of accountants employing junior and senior accountants, and these firms are now looking to the schools of commerce for suitable recruits for their staffs.

Harold Benington, C. P. A., President of the Illinois Society of Certified Public Accountants, in an address delivered in Chicago, December, 1915, at a convention of the National Commercial Teachers' Federation, said:

"We, the public accountants, have to rely to a very large extent upon you gentlemen for the recruits that enlist for services in our offices. We rely upon you to send us men who have undergone the preliminary training and are ready for active service. We don't expect you to send us veterans, but we do expect men who studied the rudimentary theory of tactics and know how to handle their tools.

"It seems to me that your share of the work lies in constantly improving and expanding the character of the instruction which you offer to your students, and that our share of the work lies to a very large extent in encouraging young men who have just begun business, or who are just about to enter it, to take your courses of instruction, making them realize that their immediate earning capacity is going to be increased."

Robert Montgomery, Ex-President of the American Association of Public Accountants, now a member of the Executive Committee of the American Institute of Accountants, said in a recent address:

"Something must be done at once to increase the number of accountants. Already the amount of work devolving upon the reputable accountants of the country is considerably in excess of their normal capacity. The present difficulties will be enormously enhanced unless we can secure from our institutions of learning, a vastly greater number of qualified accountants."

The leading institutions of education, both public and private, are now offering instruction in accounting. This text is designed for use in those schools that desire to train

students to become junior accountants associated with firms of public accountants and auditors, students who are looking forward to the time when they can qualify for promotion to positions as senior accountants, and be prepared for the professional examinations for the degree "C. P. A."

Accounting, theory and practice, Auditing and Commercial Law are considered basic subjects in courses of this nature. There is a distinction between Accounting and Auditing. However, the term Accounting comprehends audits, among other things, and Auditing presupposes a knowledge of accounting. Commercial Law is not developed herein as a distinct subject, but rather it is intended to show its contact with Accounting.

In preparing this treatise, we have, therefore, correlated these subjects so that the student obtains a view of each in its relation to the problems of the public accountant and auditor. As the subject matter is developed, the student learns the relation of Accounting and Auditing and perceives the contact of Commercial Law with Accounting.

A knowledge of the principles of bookkeeping and elementary accounting and of Commercial Law is a prerequisite to satisfactorily comprehending the principles of Public Accounting and Auditing.

The author desires to take this opportunity to express his appreciation of the help and inspiration received from those instructors, professional accountants and others, who have given material assistance in compiling the manuscript and in reading the proof.

J. F. SHERWOOD, C. P. A.

Cincinnati, Ohio.
July 1, 1920.

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Chapter One

Accounting firms usually classify their employees as JUNIORS and SENIORS. In large firms there may be several different STAFFS located in different cities. A staff will be under the supervision of a SUPERVISING or MANAGING SENIOR and he in turn may be under the direction of a PARTNER of the firm.

THE WORK OF THE JUNIOR

At first a junior will usually be assigned to work under the direct supervision of a senior who is familiar with the different phases of the field work and he will be instructed as to just what to do and how to go about it. In due time, however, he will be sent out only with general instructions from the senior who may not accompany him and he will be expected to know how to proceed with the work.

Policies of the firm must be thoroughly understood. They will vary but every firm has certain policies that it expects all employees to adhere to closely. Juniors, seniors, the managing senior, and even a partner will be required by all firms to prepare and keep a set of WORKING PAPERS showing a complete record of work completed. The arrangement and scope of these working papers will naturally vary. They will be made up of SCHEDULES containing records and figures arranged in a systematic order so as to show conclusions; how the conclusions were arrived at; why, in some cases, the figures differ from the book figures; and to show items not appearing in the books of account at all.

Briefly the duties of the junior will be the verification of bank and cash balances, checking footings, checking and testing postings, vouching entries, verifications of securities, taking Trial Balances, checking inventories, making schedules and a variety of similar work.

In accounting terms the work to be performed is referred to as an ENGAGEMENT and the party for whom it is to be done is spoken of as a CLIENT.

In undertaking an engagement it is essential to keep in mind the work to be performed whether an AUDIT, an EXAMINATION or an INVESTIGATION; and if an audit, whether it is to be a BALANCE SHEET AUDIT or a DETAILED AUDIT. A Balance Sheet audit is frequently referred to as a PARTIAL AUDIT.

THE WORK OF THE SENIOR

Naturally the senior has certain responsibilities that do not fall on the junior. He may have one or several juniors under his supervision depending upon the nature and extent of each engagement. He will be expected to plan and direct their work, decide difficult and complex questions arising from time to time, and make a complete report of each engagement completed, submitting all necessary working papers arranged to show in detail the work performed. As a rule he will not be expected to prepare final reports for the client, this being done in the office at the direction of a supervising senior or a partner of the firm. However, the senior who expects to become a manager or a partner of the firm should learn to prepare certificates and reports from a set of working papers.

PURPOSES AND ADVANTAGES OF AN AUDIT

Minor Objects. The minor objects of an audit may be classified under two distinct heads.

(a) Detection and prevention of Fraud.

(b) Detection and prevention of Errors.

Fraud. In the beginning of professional auditing, fraud was considered the principal objective and an auditor was employed only when fraud was suspected by the management. Consequently when an auditor appeared in an office and began his investigation, the bookkeepers began to wonder who was to be the victim and in most cases the auditor was looked upon as a sort of detective. Today fraud is considered only as a minor reason and not a principal reason for an audit,t hough it is often detected by the auditor regardless of what may be the chief reason for the audit. Either a continuous audit or a periodical audit will go a long way toward the prevention of fraud and embezzlement.

Errors. From the standpoint of an audit there are certain different classes of errors and the auditor should be able to distinguish between them without any difficulty. Errors may be divided into five general classes as follows:

Errors of Principle.	Errors of Omission.
Errors of Commission.	Clerical Errors.

Offsetting Errors.

Errors of principle and commission are very similar and so important that they must be detected by the auditor. The most common errors of this class are due to the inability of the bookkeeper to distinguish between capital and revenue expenditures. Frequently items are charged to Expense which should be charged to Property accounts and vice versa.

As an example of each class of errors, the following list was compiled from actual auditing practice:

Errors of Principle. (a) Sales were made to a number of customers residing in Canada. These customers would remit by check and the checks were deposited in the bank but the custom of the bank was to accept checks on Canada for collection only. The bookkeeper entered all such checks as cash receipts and added them to the bank balance as soon as deposited. One of these checks was included in the cash balance at the close of the fiscal period.

(b) In analyzing the account with Buildings, it was discovered that an end wall of a concrete building had partly caved in. The cost of repairing the wall was $2,195.30 and this sum had been charged to the Buildings account instead of to Building Expense account.

Errors of Commission. (a) On the credit side of the Selling Expense account an item of $1.00 was found without a posting reference. Inquiry of the bookkeeper revealed that at that date the ledger was out of balance that sum and he had made the entry in order to "force" the balance.

(b) An invoice for $100. was paid but subsequently included in a statement rendered and paid again by the bookkeeper.

Errors of Omission. (a) The bookkeeper failed to deduct discounts from a number of invoices although they were paid in the discount period according to terms.

(b) Delivery service was rendered in behalf of another company but not billed nor collected.

(c) In auditing the books of a Hardware Company it was found that a plumber had rendered service amounting to $45.40, but this had not been billed nor collected, consequently did not appear on the books of original entry.

Clerical Errors. (a) Accounts Payable column in purchases journal overfooted $10.00.

(b) The total of the column in the purchase journal known as "General Expense" for June was posted to the Postage account.

(c) The footing of the sales book for April, $18,546.90, was posted as $18,564.90. (This is known as a transposition of figures and is a very common error.)

(d) An invoice for $4.97 was entered as Postage instead of Stationery and Printing.

Offsetting Errors. (a) An account with a customer in the customers' ledger was overfooted $10.00 on both sides and the controlling account with "Accounts Receivable" in the general ledger showed an overfooting on both sides of the same amount.

(b) The "Stationery and Printing" column in purchases journal was underfooted $1.00 while the "Advertising" column was overfooted the same amount, therefore, the total of the distribution columns agreed with the "Total" column.

Major Objects. The more important reasons for audits may be classified as follows:

(a) Determining a condition of affairs.

(b) An audit for credit purposes.

(c) An adjustment between partners.

(d) An audit as an aid in the adjustment of claim on account of fire loss.

(e) As an aid to bonding.

(f) Protecting stockholders and bondholders.

(g) To facilitate the sale of a business.

(h) As a basis of recovery for negligence on the part of a previous auditor.

John R. Wildman,* in his "Principles of Auditing," says with regard to the occasions for auditing:

> "Generally speaking, it may be said that auditing is done, first, to satisfy someone as to the correctness of the accounts; second, to prove or disprove some contention; third, to influence prospective purchasers of goods or proprietary interests, and prospective creditors.
>
> "While the occasions for auditing are numerous and varied, they are probably all comprehended in the following category:
>
> A. AT THE INSTANCE OF SOMEONE WITHIN THE ORGANIZATION.
>
> 1. To satisfy someone within.
> 2. To satisfy someone without.
> 3. To prove or disprove some contention on the part of someone within.
> 4. To prove or disprove some contention on the part of someone without.
> 5. To influence someone within.
> 6. To influence someone without.
>
> B. AT THE INSTANCE OF SOMEONE WITHOUT THE ORGANIZATION.
>
> 1. To satisfy someone without.
> 2. To prove or disprove some contention on the part of someone without.
> 3. To influence someone without."

QUALIFICATIONS OF AN AUDITOR

A brief summary of the necessary qualifications of a competent professional auditor would include at least the following:

*Professor of Accounting at New York University.

(a) A thorough knowledge of acccounting, embracing a complete mastery of bookkeeping.

(b) Familiarity with all the systems of accounting in general use and with the various details of office and factory methods.

(c) A fair knowledge of commercial law.

(d) Absolute honesty including a natural habit of fair dealing and the faculty of inspiring others to trust in his integrity.

(e) An extensive preliminary education and the broadest kind of business training.

(f) Analytical ability and the ability to grasp situations quickly.

(g) Ability to meet people and converse easily, and with dignity. BE A GENTLEMAN IN EVERY SENSE OF THE WORD.

RESPONSIBILITY OF AUDITORS

Anyone who holds himself out to be skilful in any trade or profession, and who is negligent in the performance of an undertaking and does not use the skill of an ordinarily skilful tradesman or professional man, becomes legally responsible and is subject to a suit and penalty for damages for such failure. This statement applies to an accountant or an auditor. His moral responsibility is undoubtedly higher than his legal responsibility. Legally, one is not required to measure up to the standard of the most skilful but only to the standard of an ordinarily skilful accountant and auditor. Morally, an auditor is responsible if he does not properly perform his duties in a manner which shall conform to the best practices of the profession.

THEORY OF ACCOUNTS

> "Accountancy comprehends the conduct of audits, examinations and investigations; devising and installing systems; criticising organizations and management; and, in some cases efficiency work."—New York State Educational Dept. Syllabus.

ACCOUNTANCY is a profession having to do with the recording, verification and presentation of facts, involving the acquisition, production, conservation and transfer of values.

ACCOUNTING is the science which treats of the systematic record, compilation and presentation in a comprehensive manner of the financial operations of a business.

ACCOUNTING SYSTEMS

Generally speaking there are but two different systems of bookkeeping and accounting—SINGLE ENTRY and DOUBLE ENTRY. It is doubtful, however, if single entry bookkeeping may be correctly called a system. It would rather seem to represent a lack of system.

A knowledge of the so-called single entry method of keeping books is necessary for there is nothing more common in the work of the accountant than to be called upon to change a single entry system to double entry. The great number of questions in CERTIFIED PUBLIC ACCOUNTANT examinations based upon this changing process is but evidence of the necessity of a thorough understanding of the proper method of procedure.

The accountant will need to know the advantages and disadvantages of single and double entry bookkeeping; the method of ascertaining profits and losses; how to prepare financial statements; and the course to pursue in the conversion of single to double entry bookkeeping.

SINGLE ENTRY BOOKKEEPING

1. The purpose of single entry bookkeeping is to keep a record of transactions with persons only, that is, with customers, creditors, and the proprietor. However, accounts are frequently kept with cash, merchandise, and a few other items of special interest to the firm.

2. The disadvantages of the system are:

(a) Nominal accounts are not kept, therefore, profits and losses are not shown.

(b) A Trial Balance cannot be taken unless the auditor goes over the journal or day book and sets up accounts and posts all entries or arranges them in columns on a working sheet.

(c) Errors which creep into the records are not easily detected.

(d) A Balance Sheet can be made up only by an inventory of the assets and liabilities.

(e) It does not provide for the determination of cost of operation of different departments nor for departmental returns.

3. To prepare a Profit and Loss statement from a single entry set of books, subtract from the net worth at the end of the period the net worth at the beginning. To this amount add amounts withdrawn from investment and subtract additional investments. The result will either indicate a profit or a loss.

4. To prepare a Balance Sheet from a single entry set of books, it is necessary to take an inventory of all assets and liabilities or to add to, or deduct from, the assets and liabilities as at the beginning of the period, the transactions of the period shown by the sundry records and memoranda.

5. To convert a single entry set of books to a double entry system is not at all difficult. The same ledger may be used if desired. First, prepare a statement of assets and liabilities. Second, determine the profit or loss for the period. Third, prepare a journal entry, debiting all assets, crediting all liabilities, and crediting the proprietor for the net investment. If the proprietor is not credited for the net profit or debited for the net loss before preparing the above entry, a second journal entry will be necessary to adjust the proprietor's account and the Profit and Loss account. If the same ledger is to be retained, those accounts which already appear in the ledger should be checked so as not to be posted again. If a new ledger is to be opened, all entries must to be posted.

DOUBLE ENTRY BOOKKEEPING

With this system a complete record of every transaction is kept showing its effects upon both nominal and real accounts. There is a constant equilibrium maintained at all times for every debit is offset by an equivalent credit, and every credit by an equivalent debit.

The advantages of double entry bookkeeping are many. Among them are to be mentioned.

(a) A Trial Balance can be taken from the ledger at any time, thereby determining the accuracy of the posting and the equilibrium of the accounts.

(b) A Profit and Loss statement can be prepared from the nominal accounts and a Balance Sheet from the real accounts without analyzing the transactions.

(c) The journal and the ledger can be balanced independent of each other thereby acting as a check one upon the other.

(**Note.** It is assumed that students taking up this course in Public Accounting and Auditing are familiar with the principles of elementary bookkeeping, both single entry and double entry, and with the ordinary procedure in actual business routine. If anyone proposes to take up this course of study who has not had a fairly thorough training in bookkeeping, it is suggested that he secure a copy of "20TH CENTURY BOOKKEEPING AND ACCOUNTING," by James W. Baker, published by the South-Western Publishing Co., Cincinnati, Ohio.

This text is commended because it is up-to-date as regards modern business methods and accounting terminology. Laboratory work is also provided for use in connection with the text, making it a comparatively simple matter to secure a theoretical and practical knowledge of bookkeeping and accounting.)

COMMERCIAL LAW

and its Contact with Accounting

The American Institute of Accountants and every state having a C. P. A. law has among its requirements an examination on commercial law.

The field of business venture with which the accountant is concerned is so broad in its scope that instances have arisen in which a knowledge of the principles of all branches of law has been necessary, excepting such subjects as admiralty, pleading, torts, patent law, questions on constitutional and criminal law, and a few other special subjects.

In examinations of large manufacturing corporations, accountants are liable to encounter questions involving the general as well as the statute laws governing corporations; the law of contracts, applying to notes, sales, agency, insurance, bailments, chattel mortgages, liens, landlord and tenant, mortgages, etc,; real property law; and the state and federal statutes relating to the duties and obligations to report the extent, nature and cost of the various branches of work.

In investigations of receiverships a knowledge of the rules and practices in the courts is necessary.

In the preparation of Income and Excess-Profits Tax returns a knowledge of the Income Tax laws and regulations is a necessity. In recent years this has become a prominent part of the accountant's work.

Examinations of testamentary trusts and estates of decedents require a knowledge of the law of real property, the law relating to wills, administration, partnership, including a knowledge of statutory and common law and equity, and of the law of practice and procedure at law in the different courts.

It will be seen, therefore, that commercial law has but few limitations. To the uninitiated, it would seem to be a very difficult matter to gain a sufficient knowledge of commercial law. However, it is not as difficult as it at first appears to be.

An accountant would not be expected to have an accurate knowledge of the various statutes of the different states, but he should know when a statute would be likely to cover the case at hand. Invariably there will be sufficient time to look up a statute, therefore, it is not demanded that accountants have more than a general acquaintance with the statutes.

Of course, such statutes as the STATUTE OF FRAUDS, the NEGOTIABLE INSTRUMENTS LAW, the UNIFORM SALES ACT, and BANKRUPTCY LAWS should be well understood. The statute of frauds and the negotiable instruments law are nearly uniform, having been adopted in most of the states of the union.

SUBDIVISIONS OF LAW

Generally speaking, law may be classified as either WRITTEN or UNWRITTEN.

Written law is the law set forth in our federal and state constitutions and our federal and state statutes.

Unwritten law comes from the reported decisions of courts. Not all rights and duties as between individuals have been defined by either state or federal constitutions or statutes. When written law does not cover a case, unwritten law applies.

The law of the land is called MUNICIPAL LAW. In this country it is partially written and partially unwritten. The written law is subdivided into CONSTITUTIONAL and STATUTE LAW. Unwritten law is often referred to as COMMON LAW.

The order of importance or precedence of the various kinds of law is as follows:

1. Federal constitutional law.
2. Federal statute law.
3. State constitutional law.
4. State statute law.
5. Common law.

A law is declared UNCONSTITUTIONAL when the courts decide that it conflicts with the laws of higher order. An example of this is the recent decision of the Supreme Court of the United States, declaring unconstitutional that part of the 1916 Income Tax Law which placed a tax on stock dividends.

Commercial law is that part of municipal law which applies to commerce, that is, to business transactions.

The following chart shows clearly the main divisions of Municipal law:

Municipal Law.
- 1. Constitutional
  - Federal
  - State
- 2. Statute
  - Federal
    - Civil
    - Criminal
  - State
    - Civil
    - Criminal
- 3. Common
  - Civil
    - Suits at Law
    - Suits in Equity
  - Criminal

A. THEORY QUESTIONS

1. What are the major objects of an audit? C. P. A. Mich.

2. Give a brief outline of the duties and responsibilities of an auditor and what special qualifications and training he should possess. C. P. A. La.

3. Explain how certified statements extending over a period of years might facilitate the sale of a business.

4. (a) What is your understanding of the term accounting?
(b) What constitutes a scientific system of accounts?
C. P. A. Ind.

5. Define bookkeeping. State various kinds with explanations. C. P. A. Mich.

6. State the relative advantages and disadvantages of single entry and double entry bookkeeping. C. P. A. Ohio

7. State the essential principles of double entry bookkeeping, and show wherein it differs from single entry bookkeeping. C. P. A. N. Y.

8. The A. I. Mfg. Co. employs a staff of bookkeepers. The head bookkeeper has not studied the theory of accounting, neither has his experience been extensive. He understands double entry bookkeeping, but he cannot be described as a well trained accountant.

Previously the A. I. Mfg. Co. has been satisfied with annual accounts prepared by competent auditors. They decide to have monthly statements of accounts in the future, and with this end in view, instruct the head bookkeeper to prepare statements on the same lines as the last annual accounts were prepared.

State several imaginary errors of principle that might not unreasonably be found upon an expert examination of his work. C. P. A. Ill.

9. How would you determine the profits for a given period from a set of books kept by the single entry system, the capital at the beginning of the period being known? C. P. A. Me.

10. What information can you get from a set of books kept by double entry which you can not get from a set kept by single entry? C. P. A. Mich.

B. ACCOUNTING PROBLEMS

1. The following information is obtained from a set of books kept by the single entry method:

Capital at Beginning of Period	$8,500.00
Withdrawal from Investment during Period	1,000.00
Additional Investment during Period	2,500.00
Present Capital	12,500.00

Find the net profit or loss.

2. Day and Wright have been doing business as partners, and have kept their books by single entry. From their books and Inventory you find the following Assets and Liabilities: Mdse. $9,241.00; Cash, $850.00; Real Estate, $3,000; Bills Payable, $975.00; W. M. Day's Capital, $5,390; T. J. Wright's Capital, $6,400.00. They owe personal accounts, $4,175.00. Persons owe them, $6,941.00. Store fixtures, $571.00. Profits are shared equally.

Determine the loss or gain. Draft a journal entry to change the books from single entry to double entry, assuming that the old ledger is to be retained and used with the new system.

3. Prepare steps and show procedure necessary to convert to double entry from single entry the schedule of assets and liabilities of which, taken from the latter, appear as follows:

Assets

Cash	$12,000.00
Merchandise Inventory	7,500.00
Notes Receivable	1,500.00
Accounts Receivable	5,000.00
Real Estate	3,500.00
Plant and Equipment	2,000.00
Furniture and Fixtures	1,000.00
	$32,500.00

Liabilities

Notes Payable	$ 4,000.00
Accounts Payable	8,500.00
Excess of assets over liabilities, being capital	20,000.00
	$32,500.00

(Assume that a new ledger is to be opened. Draft a journal entry to change the books from single to double entry but do not set up ledger accounts.) C. P. A. Ind.

C. LEGAL QUESTIONS

1. What is meant by "municipal" law?

2. Name three kinds of "municipal" law.

3. Show wherein constitutional law differs from statute law.

4. Common law is sometimes also called the "unwritten" law. Explain why.

5. Give the order of precedence.

6. When there is a conflict between a statute and common law, which takes precedence?

7. Why is a general knowledge of legal principles desirable?
C. P. A. Ind.

8. (a) Define commercial law.
(b) What are the general divisions of law?
C. P. A. Mich.

Chapter Two

BEGINNING AN AUDIT

Engagement Blank. Accountants as a rule have a form known as an engagement blank. This is carefully filled in at the time the agreement is made or as soon thereafter as is convenient. The form of engagement blank used by the author is illustrated on page 18. The form may vary, but should show all the facts in connection with the agreement made with the client. It is important that an auditor should have with him a copy of the engagement blank for convenient reference.

Letter of Introduction. In starting out on an engagement one is sure to come in contact with a number of different persons. Naturally he will go first to the client. He will also need to meet heads of departments and others in arranging to begin the work. It is, therefore, important that he have a letter of introduction. Remember an auditor is engaged in professional work and the nature of his work and the liberties extended him are such that he should be properly introduced.

Equipment. In the way of equipment, an auditor will need journal, ledger, and analysis paper. Analysis paper may be secured with almost any number of columns. Fourteen columns is well adapted to the use of the Working Sheet and is therefore preferable. He will also need black, blue and red pencils, an eraser, a ruler, bank certificates in blank, time and expense report blanks, and a memorandum book.

NATURE OF ENGAGEMENT

The first thing of importance at this point is to know in your own mind exactly what you are going to do. Heretofore the business public has depended upon the auditor and accountant as to the scope of the work and in many cases the work has been started without knowing in advance exactly the nature and scope of the engagement. There should be a clear understanding reached with the client by the accounting firm, and this in turn should be conveyed to the senior in charge of the audit. The junior should understand definitely just what part of the audit he is to be responsible for and should proceed accordingly. Of course, it is needless to say that he will get his information direct from the senior and not from the client.

(*Continued on page 19*)

ENGAGEMENT BLANK

Office:
309 W. Third Street
Cincinnati, Ohio

J. F. Sherwood
Certified Public Accountant
and Auditor

Telephone:
Main 2647

Cincinnati, Ohio,

1. Client The Blank Manufacturing Company..
2. Official position...Board of Directors..........
3. Address....Indianapolis, Indiana...........
4. Conference....C. H. Becker, Chairman.......
5. File No.....A245.................................
6. Telephone No..... Main 24.........................
7. Report to be addressed to.Mr. Becker.............
8. Account to be opened with.The Blank Mfg. Co...
9. Nature of engagement..Balance Sheet Audit....
   for credit purposes.........................
10. Work to be done at..their office...............
11. Nature of the business.manufacturing............
12. When to be commenced.Jan. 15, 1919 ....
13. Probable time required..two weeks................
14. Accountants required one senior; two juniors
15. Rates...regular.................................
16. Additional information..No previous audit has
   ever been made but an internal check
   is maintained. Mr. Becker called at
   our office Dec. 20, 1918................

Engagement No.......One... Date completed...........

Assigned to staff......A...... Report mailed............

In determining the nature of the engagement and making arrangements for the audit with the client, naturally it is frequently necessary to explain the different classes of audits. The client is likely to state that he wants a complete audit when, as a matter of fact, he wants only a Balance Sheet audit. It is of the utmost importance that there be no misunderstanding between the auditor and his client as to the exact scope of the audit.

THE VALUE OF AN AUDIT

The value of an audit will naturally depend upon each individual instance. Business men have been somewhat slow to realize the actual benefits to be derived from periodical audits by professional accountants, but today the importance of an audit is generally recognized by the business community. It is not infrequent, however, that we still hear business men say that in their particular case an audit is unnecessary. They say that they have absolute confidence in their bookkeeper or accountant and that he is able to prepare annual statements that are just as accurate as anyone could prepare. Others say that they know exactly where they stand in the financial sense and do not need an outsider to point out defects, or to plan improvements in the accounting system in use.

Questions such as the following should cause business men, stockholders, directors, investors and others to realize that such arguments as the above are groundless: Are you certain that your bookkeeper is competent to furnish an accurate statement of financial condition or of earnings? Has your general manager had sufficient accounting training and experience to judge of the correctness of the reports which he submits periodically? Do you know that corporations frequently pay dividends which have not been earned, though it is illegal to do so? Is your general manager competent to prepare for the United States Government, returns for Income and Excess-Profits Taxes? Even though your attorney is consulted with regard to these returns, are you sure that he fully comprehends the application of the Income Tax Law and all the regulations of the Treasury Department? Is he able to interpret your accounts and determine the accuracy of your returns? It is such questions as these that only a professional accountant with wide training and experience is competent to pass upon.

A bookkeeper may perform his detail work so accurately that for years his books are always in balance and errors in posting or in footing the accounts are unknown, yet the statements which he presents are not only in such form as to convey little information of value, but the figures which he shows as earnings may never be correct. An audit of his books may disclose the fact that accounts receivable, amounting to thou-

sands of dollars, have been carried at full value though known to be uncollectible. He may not have made provision for depreciation of plant and machinery. Equipment which has become worthless because of depreciation or obsolescence may be shown in the statements at its original cost.

These are some of the things which an average bookkeeper, even one whose services command a big salary, knows but little or nothing about. If he does know something of the necessity for adjustments of this kind, his lack of experience and theoretical knowledge is a dangerous thing, and his attempt to put this theory into practice is likely to mar the result.

Don't think for a moment that the present day work of an auditor is merely a checking of the footings and postings. This part of his work requires the least amount of ability and experience. It is an auditor's duty to go much further—to determine the accuracy of the figures stated on the books of account; to distinguish between capital and revenue expenditures; to determine the actual value of accounts with customers through a process of testing, or, if necessary, to correspond with each customer to secure a verification of the account; to determine a conservative and sound basis for the estimation of depreciation on all assets; and to secure authority for making all necessary adjustments. These things can be brought about through courteous cooperation between the officers and employees of the company and the accountants.

The professional accountant's work would not be satisfactory if he were to submit statements of financial condition which are simply in accord with the books of account. He must determine that none of the assets are overvalued and that all liabilities are stated. The latter may mean the determining of liabilities on account of accommodation endorsements of notes and other negotiable instruments, guaranties, warranties, etc. The head bookkeeper of a concern, in preparing statements of financial condition, is certain to be influenced by the wishes of the management, but an accountant must of necessity prepare his statements so as to show the absolute facts; he must be impartial. To fail in this is to become morally and legally liable for having failed to use the skill of a professional accountant.

Periodical audits by professional accountants are necessary in hard times when competition is keen and profits small, because in such times operating cost must be carefully analyzed and reduced to a minimum. The auditor must determine where the expenditures have been made, why they were made and what the results were. He must find out if there are any leaks and suggest a way to stop them.

An auditor's report may disclose that during a period when sales were abnormally large, the results show a loss as compared

with previous periods when sales were considerably less. His report may show that one department is suffering a loss, yet the entire business shows a gain. His report may show that operating expenses in one department are abnormally high and he may be able to show how they could be lowered.

In many instances, it has been found profitable to secure an accountant to install a system of accounting and to make arrangements for the accounting to be done under his supervision. When this is done, the work of the bookkeeper is performed and statements are prepared under the oversight of a highly trained and widely experienced professional accountant, and usually at a very reasonable cost as compared with the value of the accountant's services if confined to the individual firm; yet with such arrangements the accountant may be consulted any time, even over the telephone. Unusual and difficult problems may be placed before him before the bookkeeper has recorded them, thus avoiding errors and misstatements.

There is not the slightest doubt as to the value of an audit when performed by a skilled professional accountant or auditor, and it is exceedingly doubtful if any corporation or business firm can afford to do without an audit.

The professional accountant is an efficiency engineer in times of prosperity. He sets the signals which, unless they are disregarded, keep the business train running without accident. He is the wreckmaster who gathers up the pieces, sets them on the track and starts them going—if possible—after a concern has been ditched.

When a rich man dies, the public accountant examines and appraises his estate. His range of activities covers the whole field of business existence, from birth to death, and the interval between.

KINDS OF AUDITS

Audits may be either complete or partial. A complete audit is known as a DETAILED audit; a partial audit is usually known as a BALANCE SHEET audit. Since the average business man has no idea of the difference in the two main classes of audits, a careful explanation must be made so that he will know in advance just what kind of an audit he is getting. He will frequently ask the auditor to make a recommendation in the matter. It is quite impossible and inadvisable to do so without a preliminary inspection of the books and conditions existing. The detailed audit is the ideal audit but the time and expense of such an audit is not always advisable nor is it always necessary. In determining this matter much will depend upon whether a satisfactory internal check has been maintained.

Internal Audit. By an internal audit or check is meant a continuous audit by someone within an organization, or by the system being so planned that no one employee has complete control of any part of the accounts. A properly planned internal check is important and when carried out satisfactorily, a Balance Sheet audit will be found sufficient, unless fraud or dishonesty is suspected.

While large firms usually employ someone who acts as auditor and who maintains a continuous audit, yet a large majority of firms do not employ such a person, but simply plan the office work in such a way as to secure the best internal check. The exact division of the work in an office so as to secure a satisfactory internal check would depend very largely upon the surrounding circumstances.

In planning a system of accounts for a jobbing house, wherein five persons kept the books, did the billing, made the city collections, handled the general and petty cash, and paid all the invoices, the following method was advocated and later found to be very satisfactory:

It was arranged for one person to keep the general ledger and record the invoices; a second to handle the cash; a third to keep the sales ledger; a fourth to do the billing; and a fifth to make collections, etc. The work may be still further subdivided, depending upon the volume of business. For instance, one man might handle only cash receipts and another man handle cash payments, or one man might handle cash receipts from customers keeping a special customers' cash book. All this subdivision of the work will depend upon the volume of business. The important feature is that the cash book and ledger be kept by different persons so that one person acts as a check upon the other. Some accountants recommend that persons in the office exchange duties at times, the theory being that in so doing one person might detect dishonesty on the part of another. From the standpoint of efficiency, this procedure might be argued as unwise.

Without a doubt, vacations should be insisted upon. The author recalls an experience of a teller in a bank who for a period of three years constantly embezzled the bank, and although the books had been audited periodically by bank examiners, he had been able to cover up the shortage so that it had not been detected, but finally, while away on a vacation, the bank examiner made an unexpected call and during the process of his investigation uncovered a shortage of $10,000 in the teller's accounts. This illustration is mentioned as one reason why vacations should be insisted upon from the standpoint of an internal check.

Cash Audit. The so-called cash audit is practically a balance sheet audit or partial audit, but it is difficult to understand how an audit of cash could be made without leading

to the consideration of many other accounts and records. Fraud and errors of principle are not necessarily confined to cash in any sense, and are far more likely to be uncovered somewhere else.

Balance Sheet Audit. A Balance Sheet audit is made with the view of preparing a correct Balance Sheet as at a certain date. It not only includes the verification of stated assets and liabilities but also the discovery of any unstated assets and liabilities. Furthermore, the auditor must ascertain if all the liabilities have been incurred with proper authority. In the case of a corporation it will be found frequently that certain liabilities were incurred without authority from the board of directors.

Detailed Audit. As stated above, the detailed audit is the ideal audit. It comprehends a complete audit of all income and expenditures during the period, including the checking of all records, vouchers, footings, postings, etc. The detailed audit is seldom carried out in full. A process called TESTING is resorted to quite often in both a Balance Sheet and a detailed audit. It consists in picking out the transactions for a certain period and if, after carefully vouching these transactions they are found to be correct, it is then assumed that the transactions for the whole period under audit are reasonably correct.

Contingent Fees. The question as to the advisability of an auditor accepting a contingent fee frequently comes up. While under certain circumstances it may be safe to accept a fee based upon the results of the audit, it is doubtful if the plan is to be encouraged. At any rate it is not considered good ethics by the American Institute of Accountants which has gone on record as opposed to the practice. To illustrate what is meant by a contingent fee, a client approaches an auditor stating that he desires an audit made with the view to obtaining a loan from his banker and states that the fee will be based upon the auditor's success in aiding him to secure the loan through the preparation of a Balance Sheet for credit purposes. The auditor who undertakes such an engagement would not be likely to prepare an impartial report.

Audit Program. At the beginning of the engagement the auditor should prepare a program. Naturally it will differ, depending upon the scope of the engagement, the nature of the business, and the purpose of the audit, but it usually will be along lines similar to the following:

1. Count the cash; verify bank balances; read minutes.

2. List notes and securities on hand.

3. If a Trial Balance is furnished, check it with the general ledger.

4. Check list of accounts receivable and accounts payable with controlling accounts.

5. Check any other subsidiary lists of accounts with controlling accounts.

6. Check extensions and footings of inventories; test the inventory.

7. Verify outstanding capital stock by comparison of stock ledger accounts with stubs of stock certificate book.

8. Check all footings of books of account, both original and final; check all postings or transfers from one book to another.

9. Review cash disbursements; compare with cancelled checks.

10. Ascertain if proper provision has been made for depreciation.

Legal Responsibility of Client. It is not out of place here to mention the fact that it is always advisable to determine the legal responsibility of a client before accepting an engagement. If someone within an organization seeks to have an audit made, it is necessary to ascertain whether or not he has any right to engage the services of an auditor, and also as to whether or not he is employing you personally, or is merely acting as an agent of the company.

CLASSIFICATION OF ACCOUNTS

It is important that an accountant or auditor should thoroughly understand a proper classification of accounts. In the next chapter there is to be taken up what is known as a Balance Sheet audit; therefore, it is necessary at this point to devote a brief discussion to the subdivisions of accounts. Since a Balance Sheet is made up of ASSETS and LIABILITIES, these will now be discussed and classified.

REAL ACCOUNTS

Accounts are divided into two general classes—REAL and NOMINAL. It is the real accounts that appear in the Balance Sheet and are classed as assets and liabilities; they may be either PERSONAL or IMPERSONAL. There are three classes of personal accounts: accounts with customers; accounts with creditors; and accounts with owners or proprietors. Accounts with customers are usually classed as CURRENT assets. There might be an exception to this in the case of an open account, the terms of which would indicate that it would not become due within a year. Some authorities hold that all current assets must be those which can be realized upon within the current fiscal period, or, at least, within a year. However, it is conceded good practice to class all accounts with customers as current assets as long as these accounts are collectible. Once an account is considered uncollectible, or its collection as being doubtful, it should immediately be charged off and should not be included as a current asset without the proper depreciation being set up.

Accounts with creditors are considered as CURRENT liabilities; like accounts with customers, they are usually due within a short time and, therefore, provision must be made for their liquidation within the current fiscal period.

The accounts with the owners or proprietors of a business are classified on the liability side of the Balance Sheet, but are usually listed separate from the liabilities in a section devoted to proprietorship accounts. They may be in the form of an account with a single owner, accounts with partners, or accounts with capital stock, and SURPLUS or DEFICIENCY. In the case of a corporation, net profits are usually credited to a Surplus account or they might be credited to an Undivided Profits account, in which case this account would also appear among the proprietorship accounts. Net losses are debited to the Surplus account, but when a business becomes insolvent, it is then necessary to set up a Deficiency account debiting it with the net excess loss. A Deficiency account shows that the business has been conducted at a loss and that the value of the stock owned by stock-holders has decreased in value equal to the amount of the deficiency.

(*Continued on page 27*)

CLASSIFICATION OF ACCOUNTS

- Accounts
  - Real
    - Personal
      - Assets—Current
        - Accounts with Customers
      - Liabilities
        - Current
          - Accounts with Creditors
        - Proprietorship
          - Accounts with Proprietors
    - Impersonal
      - Assets
        - Current
          - Cash
          - Merchandise
          - Notes Receivable
        - Fixed
          - Machinery
          - Buildings
          - Equipment
      - Liabilities
        - Current
          - Notes Payable
          - Dividends Payable
          - Accrued Expenses
        - Fixed
          - Mortgages
          - Bonds
          - Collateral Loans
  - Nominal
    - Income
      - Merchandise Sales
      - Dividends on Investment Stock
      - Interest on Notes Receivable
    - Operating Cost
      - Advertising
      - Salaries
      - Rent
    - Special Profits
      - Profit on Real Estate
      - Sales of Waste Paper
      - Dbt. Accts. Collected
    - Special Losses
      - Burglary Loss
      - Loss by Flood

It will be seen, therefore, that personal accounts affect both sides of the Balance Sheet, accounts receivable appearing on the debit side as assets, and accounts payable and proprietorship accounts appearing on the credit side of the Balance Sheet as liabilities.

Impersonal accounts represent either assets or liabilities. If assets, they may be either current or FIXED. Impersonal current assets would include such real accounts as Cash, Merchandise, Notes Receivable and any other accounts that can be converted into cash quickly and that do not constitute a fixed investment. On the other hand, impersonal fixed assets are those accounts which represent fixed investments, such as machinery, buildings, equipment, land and all property possessed and used directly by the owner himself for his enjoyment, or for business purposes, and maintained in fixed condition for long periods of time subject only to wear and tear and depreciation on account of use. Impersonal liabilities are likewise classified as either current or fixed. Those obligations which must be liquidated within a short time are current liabilities and those obligations, the liquidation of which is deferred to a future date usually beyond the present fiscal period, are fixed liabilities. Notes payable, dividends payable, all accrued expenses, deposits, guarantees, and similar accounts, are classified in the Balance Sheet as current liabilities, while mortages, bonds and collateral loans which do not mature within a year or within the present fiscal period, are listed as fixed liabilities.

> The Public Service Commission of New York says: "Funded debt comprises all debt which by the terms of its creation does not mature until more than one year after date of creation".

There is another subdivision of assets that might be mentioned here, that is, assets may be either TANGIBLE or INTANGIBLE. Kester* in his "Accounting, Theory and Practice," says: "Asset and liability accounts may be called 'real' or 'specific', because they represent, in the main, properties owned or owed which are definite and usually tangible." Intangible accounts include such accounts as good will, trade marks, patents, copyrights, titles, trade names, franchises, etc.

NOMINAL ACCOUNTS

Nominal accounts are subdivided into four classes: first, income accounts; second, operating cost accounts; third, special profit accounts; fourth, special loss accounts. Nominal accounts are sometimes referred to as ECONOMIC accounts.

*Roy B. Kester, Columbia University

Wildman,* in his "Principles of Accounting", says:

> "Real accounts are those which reflect financial conditions.
>
> "Nominal accounts are those which reflect changes in financial conditions."

Under the heading of Income should be included accounts representing mercantile income, income from commissions, income from professional fees, banking income, etc. The exact classification will depend upon the nature of the business. If a business is a mercantile business, its principal income will be represented by returns from sales, and practically all other income will be in the nature of special profits. If the business is a professional business, the principal income will be from fees, and all other income will be in the nature of special profits. A stock broker's income would be in the nature of commissions; therefore, it is to be noted that in preparing a Profit and Loss statement, the arrangement of the accounts will depend upon the nature of the business. A man whose business is mercantile, but who chances to make a sale of a piece of real estate at a profit, would thereby create a special profit not in his usual line of business. Likewise, a loss by burglary is to be considered a special loss and not a customary loss in the usual course of the business. Operating costs, sometimes classed as operating expenses, are the expenses incident to the operation of a business such as advertising, salaries, rent, heat, light and all similar expense accounts. Special profits and special losses are sometimes listed as EXTRAORDINARY or EXTRANEOUS profits and losses.

A Profit and Loss statement is composed of nominal accounts. The usual procedure is to list the regular income accounts first, followed by the operating expense or operating cost accounts, thereby determining the net profit or net loss from operation. This would be followed by adding the special profits and deducting the special losses, to ascertain the net profit or net loss for the period. Naturally the owners, including the partners and stockholders, are interested in and want to know, first, what their total net income has been; second, what their total operating cost has been in producing the net income; third what additional profits there have been; and fourth, what additional losses have been incurred.

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*Professor of Accounting at New York University.

THE LAW OF CONTRACTS

Note: Since the LAW OF CONTRACTS is without a doubt one of the most important parts of commercial law, naturally, the accountant is primarily concerned with it and, therefore, beginning with this chapter a brief discussion of the different phases of the law of contracts will be given.

Essential Conditions. Before an agreement partakes of the nature of a contract and becomes legally enforceable, there must be certain conditions adhered to. The agreement must be between two or more COMPETENT parties, based upon SUFFICIENT consideration, to do or not to do some LAWFUL, POSSIBLE thing. The agreement must be mutual, that is, the minds of the parties must have met. It will be seen, therefore, that there are four essentials to every contract:

1. Competent parties.
2. Mutual agreement.
3. Sufficient consideration.
4. Legal subject matter.

Methods of Making Contracts. There are but two ways of creating a contract. One is by a WRITTEN AGREEMENT and the other is by an ORAL UNDERSTANDING between the parties. Undoubtedly the most important thing to set forth in this lesson is that it is always best to make a written contract. A written contract may be under SEAL or may be a SIMPLE contract.

An oral contract may be either EXPRESSED or IMPLIED. It is expressed when its terms are stated and agreed to by the parties. It is implied when its terms are inferred from the acts of the parties. A great many contracts are implied. For instance, if one calls in a physician in case of illness, it is understood that he expects to pay for the service whether he says anything about it or not. The same is true when one orders groceries delivered at his home without reference to payment.

Certain Contracts Must be in Writing. The Statute of Frauds requires that certain contracts must be in writing, or at least there must be a memorandum in writing. This statute has been adopted by nearly all the states and it is practically uniform.

Documents of greater importance must usually be made under seal. The state statutes cover this and, as they differ to some extent, it would be best to become familiar with the statutes covering this point in your state.

Contracts not made under seal are said to be CONTRACTS BY PAROL, or simple contracts. They may be either oral or written.

A. THEORY QUESTIONS

1. Distinguish between a Balance Sheet audit and a detailed audit. C. P. A. Ohio.

2. Large business concerns frequently have on their staff what are known as "internal auditors". Under such conditions, would you approve the employment of Certified Public Accountants to make periodical audits? Give reasons for your answer. C. P. A. Ind.

3. Under what circumstances would you advise a client that a complete detailed audit should be made? Give your arguments to convince him that a test audit would not be satisfactory. C. P. A. Ill.

4. How is the position of an auditor affected if the system of the concern under audit is defective as to internal check? Inst. Ex. 1918.

5. Why is it advisable to determine the legal responsibility of a client before accepting an engagement?

6. What do you understand by (a) personal account, (b) impersonal account, (c) real account, (d) nominal account? C. P. A. Ind.

7. Define the following:
   (a) Fixed assets and fixed liabilities.
   (b) Current assets and current liabilities.
   C. P. A. Mich.

8. In making "detailed" audits some auditors verify all postings and footings of general and subsidiary ledgers, even though controlling accounts are kept. State reasons for and against such procedure. Inst. Ex. 1919.

B. ACCOUNTING PROBLEMS

1. The Trial Balance of the Yellow Pine Timber Co. on January 1, 1920, was as follows:

Cash	$ 2,618.03	
Accounts Receivable	21,111.17	
Inventory	36,133.32	
Unexpired Insurance	559.44	
Plant and Equipment	352,109.75	
Timber and Lands	551,539.31	
Preferred Claims		$ 37,011.99
First Mortgage Bonds, 6s		212,500.00
Bond Interest Accrued		4,533.24
Unsecured Creditors		64,471.64
Capital Stock		400,000.00
Surplus		245,554.15
	$964,071.02	$964,071.02

Classify the accounts in accordance with the outline shown on page 26. C. P. A. N. Y.

(Note. The date of this Trial Balance is January 1, 1920, hence all nominal accounts have been closed into surplus. All accounts appearing in the Trial Balance are real accounts, but they should be classified, showing which are personal and which are impersonal with a further subdivision into assets—current and fixed; and liabilities—current and fixed.)

2. The office of a firm of traders, doing business in San Francisco was destroyed by an earthquake. The books of account, which had been fully posted, were badly damaged. The following ledger accounts were found to be legible: Purchases, net, $69,000; Discounts Lost, $640; Discounts Gained, $3,450; Sales, $54,000; Bills Receivable, $33,000.

Inquiry at the bank disclosed a balance on deposit, $129,000. Bills receivable amounting to $45,000 had been discounted at the bank. An audit of the checks paid by the bank showed that $99,000 had been paid creditors (including $60,000 notes payable).

A Balance Sheet prepared at the last closing of the books was produced, containing the following items: cash, $60,000; accounts receivable, $126,000; loans receivable, $24,000; real estate, $90,000; notes receivable, $78,000; capital, $318,000; notes payable, $60,000.

Prepare a Trial Balance supplying the missing accounts.
C. P. A. N. Y.

(Note. You should set up skeleton ledger accounts with Real Estate, Cash, Notes Receivable, Loans Receivable, Accounts Receivable, Accounts Payable, Capital, Sales, Purchases, Discounts Gained, and Discounts Lost.

1. Debit or credit each account with the amount shown in the Balance Sheet prepared at the last closing of the books.

2. Set up the balances of those ledger accounts which were found to be legible after the earthquake.

3. Make the necessary adjusting entries from the information obtained at the bank and from an audit of the checks paid by the bank.

After this work has been completed, you will have no difficulty in preparing a Trial Balance.)

3. From the Trial Balance prepared in the solution of Problem No. 2, you may prepare a list of the assets and liabilities. List the current assets first and the fixed assets second. Likewise, list the current liabilities first and the capital second. Show the amount of increase or decrease in the net worth of the business.

(Note. You may assume that the entire stock of merchandise was destroyed by fire following the earthquake.)

C. LEGAL QUESTIONS

1. What are the essential elements to every valid contract? C. P. A. Mich.

2. What special element is required in some contracts but not in all? C. P. A. Ohio.

3. How is a contract made? C. P. A. N. Y.

4. Can a contract be implied? C. P. A. Mich.

5. Where a contract is in writing is it admissable for one of the parties to it, to vary it by proving that at the time it was entered into, such was their oral agreement? C. P. A. Ill.

Chapter Three

Books of Account. Before proceeding with a Balance Sheet audit, the auditor must thoroughly understand the various systems of account in general use and be familiar with all books of account, both those of original entry, including AUXILIARY books, and those of final entry, including SUBSIDIARY books. By auxiliary books is meant those which contain detailed information supporting the record in the books of original entry. They include check stubs, note stubs, draft stubs, receipt stubs, bank pass books, etc.

By subsidiary books are meant subsidiary ledgers controlled by accounts in the general ledger. They include customers' ledgers, creditors' ledgers, stockholders' ledgers, cost ledgers, etc.

The following discussion and the accompanying chart is intended as a review of the ordinary principles of bookkeeping and accounting as taught in the leading texts.

BOOKS OF ORIGINAL ENTRY

The Journal. It is possible to record all transactions in what is known as a general journal and, regardless of how many subdivisions of this journal there may be in a system of accounts, all books of original entry which are used as a posting media constitute a part of the journal. James W. Baker, in his "20th Century Bookkeeping and Accounting", says:

> "The Journal is a book of original entry in which all the transactions may be recorded. If it is the only book of original entry, all the transactions are recorded in it; if the purchases, sales, cash receipts, and cash payments are recorded in special books, it contains only those transactions not recorded in these books. The record shows the date, name of the account debited and amount, name of the account credited and amount, and the explanation or information for the auditor."

Roy B. Kester, C. P. A., in his "Accounting, Theory and Practice," says:

> "A Journal may be defined as a diary or log in which the happenings or transactions of a business are recorded. Formerly it was sometimes called a day-book or blotter. The day-book or blotter record was a rough record giving all the essential data relating to each transaction without regard to accounting terminology, and was used as a sort of memorandum from which a formal record might be made in accounting terminology. This day-book or blotter, still in use in some places, has very largely given place to the journal which, either a single book or separated into many subsidiary books, is the book of original entry."

Reference to the illustration on page 35 will show how the journal might be subdivided in a highly organized system of accounts. Under such a subdivision, it will be seen that transactions of a similar nature are recorded in separate books. The saving of time in posting is evident although it is not the only reason for such a subdivision of the journal. Another reason is the fact that it enables several bookkeepers to record entries in the original books at the same time, where if only one or a few books of original entry were in use, the volume of business might be so great that the bookkeepers could not handle the work.

Therefore, in planning a system of accounts, it is always necessary to provide special records or books for recording each class of transactions in accordance with the volume and nature of the business, and depending upon the number of employees involved in recording the transactions.

Regardless of the detailed subdivision of the journal, there will still remain certain transactions that should be recorded in the general journal. A. Lowes Dickinson, C. P. A., in his "Accounting Practice and Procedure,*" says:

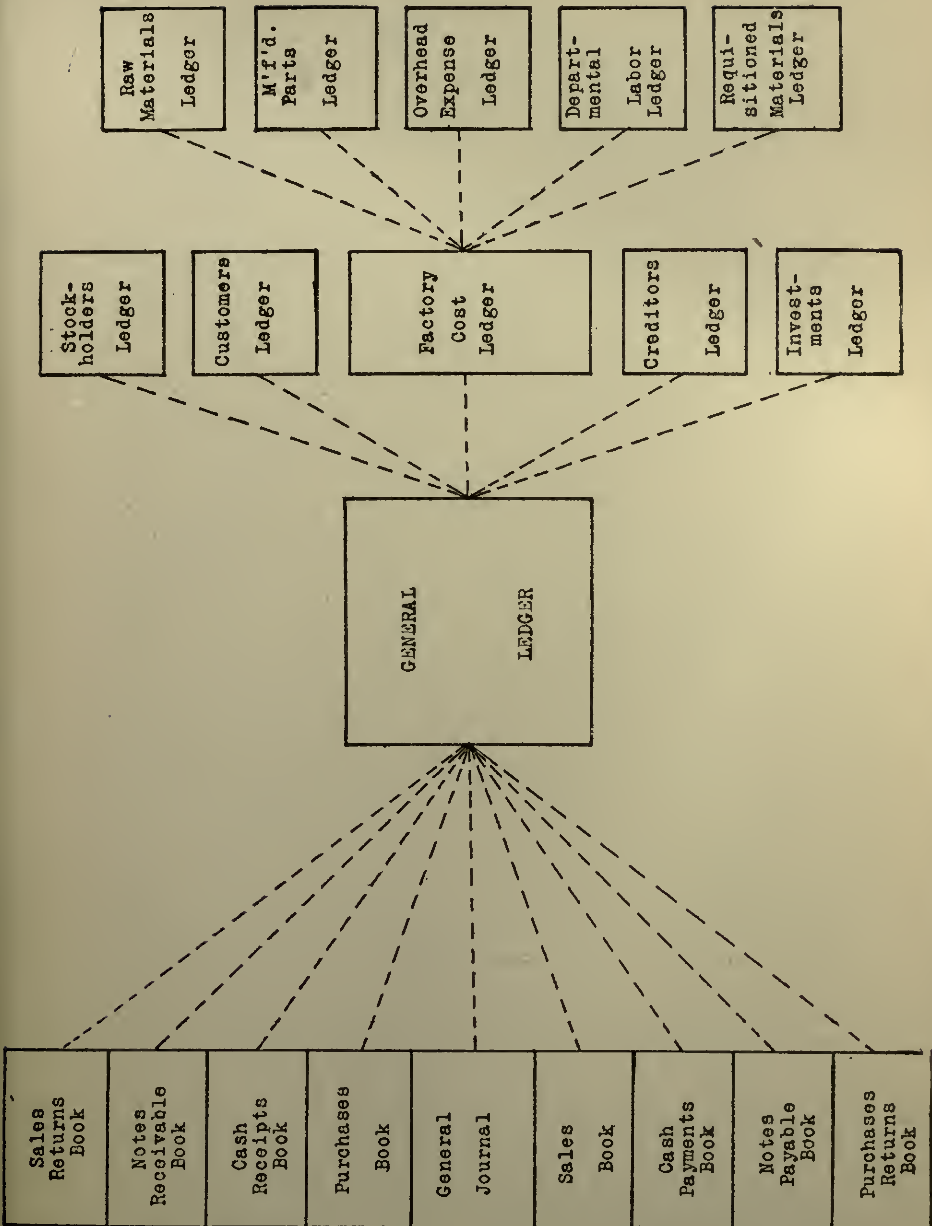
> "A journal is, however, still necessary for special entries, correction entries, and other miscellaneous matters which do not fall within the scope of any of the books or forms described."

The principal use for the general journal will be for recording opening entries at the beginning of the business, correction entries during the fiscal period, and adjusting and closing entries at the end of the fiscal period. Of course, any special entries that cannot properly be classified in the special journals will be recorded in the general journal.

BOOKS OF FINAL ENTRY

If the journal is to be subdivided into special books for the sake of saving time, for analyzing purposes, and to enable more bookkeepers to work on them at the same time, likewise, it is equally advisable to subdivide the ledger.

*Published by Ronald Press Co.



(Chart showing control of General Ledger in Modern Accounting Systems.)

The Ledger. If only a general ledger were maintained in a large firm, where there may be thousands of accounts, one can readily see that no bookkeeper could possibly keep up with the volume of work, unless some sort of a card or loose-leaf ledger were used enabling different persons to post at the same time. Hence it not only becomes advisable, but absolutely necessary, to subdivide the ledger. The process in subdividing the ledger, however, differs from the subdivisions of the journal in this respect, that the general ledger controls all accounts which are kept in what are known as subsidiary ledgers.

Subsidiary Ledgers. In an ordinary mercantile business, the principal subsidiary ledgers are the sales and purchases ledgers. From the standpoint of terminology, a number of different names have been applied to these ledgers. Accounts receivable ledger, sales ledger, customers' ledger and debtors' ledger are all synonymous terms and mean the same thing. Likewise, purchases ledger, accounts payable ledger and creditors' ledger are synonymous terms. Other terms are also used, for instance, a sales ledger may be arranged so as to show accounts with customers in either alphabetical, geographical or numerical order. In the event that they are arranged in alphabetical order, then there may be one or more ledgers with controlling accounts for each. The controlling account might be named A to C Ledger, D to E Ledger, etc. If the arrangement is geographical, the ledgers might be known as city ledgers, country ledgers, foreign ledgers, state ledgers. etc. Furthermore, the ledgers may be in the form of bound books, loose leaf books, cards or vouchers. One will frequently find a system of arranging the accounts numerically, in which case the bookkeeper in charge of a customers' ledger may not know who the customers are as he does his posting from information in memorandum form, the name of the account being represented by numbers only. Experience only will enable one to become familiar with all the different methods and plans used.

Controlling Accounts. A controlling account for each subsidiary ledger will be kept in the general ledger, and this controlling account will show at all times the exact status of the subsidiary ledger. By means of controlling accounts for the subsidiary ledgers, the general bookkeeper keeps his ledger in balance at all times without the necessity of preparing schedules of the accounts in the subsidiary ledgers.

W. A. Paton,* Ph. D., and R. A. Stevenson,† Ph. D., in their text on Principles of Accounting, say:

> "The possibility for labor saving is often dependent upon the use of controlling accounts and subsidiary ledgers. The total amount receivable on customers' accounts constitutes one distinct asset item for Balance Sheet purposes.

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*Assistant Professor of Economics in the University of Michigan.
†Associate Professor of Accounting in the University of Iowa.

The amount due from an individual customer is of little importance in the presentation of a statement showing a firm's financial condition. It is the summary of all the customers' accounts that is significant. It is obvious that for other purposes, however, a knowledge of the amount due from individual customers must be available. In order to serve both of these purposes the controlling account is used."

The chart also shows that if the business is a manufacturing business and it is desired to maintain a cost system, a separate factory cost ledger may be kept, but that this will be controlled by an account in the general ledger just the same as a subsidiary ledger with customers or creditors would be kept. At this point the system becomes still more complicated by the fact that the number of transactions affecting the cost ledger are so great that it may be necessary to subdivide that ledger and maintain subsidiary cost ledgers for special cost accounts. For instance, a separate ledger might be kept with manufactured parts and another with raw material.

THE TRIAL BALANCE

In preparing a Trial Balance from the general ledger, it will not be necessary to take into consideration any of the subsidiary ledgers unless it is desired to check the controlling accounts with the sum of the balances of the accounts in the subsidiary ledgers. This must be done at the end of each fiscal period. In most cases it is advisable to make this check at least once a month. The professional auditor, however, will never accept a Trial Balance from the general ledger without preparing schedules from all the subsidiary ledgers and making a careful comparison with the controlling account in the general ledger.

The accounts should be so arranged in the ledger that they will be in proper order for the preparation of the statements at the end of the period. The arrangement of the accounts in the Trial Balance is not a matter of great importance; however, the Trial Balance is usually prepared by following the ledger, page by page. Whatever arrangement or classification of accounts has been carried out in the ledger, therefore, will be duplicated in the Trial Balance. If the accounts have been properly arranged in the ledger, the Trial Balance will, therefore, show the accounts arranged in such a manner that it will be an aid in preparing the financial statements.

Too many bookkeepers consider the Trial Balance as an indication of the correctness of their work. This frequently leads to trouble because a Trial Balance, even though it is in balance, will not indicate or detect errors in principle, off-setting errors or errors of omission. The fact is, a Trial Balance is nothing more than a fairly reliable indication of accuracy, and simply shows the equilibrium or equality of debits and credits. Another form of the Trial Balance used by accountants, known as the Working Sheet, will be discussed later.

THE BALANCE SHEET

It has already been stated that the accounts in the ledger should be so arranged as to make it convenient to prepare a Balance Sheet. At this point, the proper arrangement of accounts in the Balance Sheet will be taken up. Conflicting theories exist.

First; Accountants in England and America do not agree with reference to the listing of the assets on the debit side of the Balance Sheet and the liabilities on the credit side. English accountants hold that a Balance Sheet is an account rendered by the business to the owner; therefore, the proprietor is credited with his assets and debited with his liabilities. Hence the Balance Sheet shows the liabilities on the debit side and the assets on the credit side. This is just the reverse of the practice by American accountants who hold that a Balance Sheet is a concrete preparation of financial facts, the debit side of the Balance Sheet showing the assets and the credit side, the liabilities.

Second; American accountants have not been able to agree as to the arrangement of the assets and liabilities on the Balance Sheet. Some list (a) the fixed assets on the debit side opposed to the fixed liabilities on the credit side, (b) the current assets on the debit side opposed to the current liabilities on the credit side, and (c) the deferred debit items opposed to the deferred credit items, while others arrange the assets and liabilities without regard to any particular classification. Some show the capital or proprietorship accounts first on the credit side, while others show them last. Some show reserves as deductions from assets. Others show them either as liabilities or as a part of the proprietorship section. Regardless of all this difference in opinion, there is gradually coming about a uniformity, and it is to be encouraged at all times.

Robert H. Montgomery,* C. P. A., expresses his conception of an ideal Balance Sheet as one which will set forth:

1. "The assets, properly valued and grouped, and arranged in the order of their availability.
2. "The liabilities also properly grouped and arranged in the order they will, or should, be discharged.
3. "If possible the excess of the assets or the liabilities should now be shown in order that there may be clearly apparent to anyone interested, the net worth, or capital and surplus, of the enterprise.
4. "A statement showing to whom the excess belongs or by whom it is due. That is, if a corporation, there should be shown the capital stock issued, the addition thereto if a surplus of assets exists, or the deduction therefrom if there is a deficiency."

A Model Balance Sheet. The Model Balance Sheet illustrated on pages 40 and 41 shows the arrangement of the different classes of real accounts in accordance with a tentative

*Of the firm of Price, Waterhouse & Company.

proposal for a uniform system of accounting to be adopted by manufacturing and merchandising concerns. The proposal was made in 1917 by the Federal Reserve Board and is the out growth of the work of the Federal Trade Commission and of Mr. Edward N. Hurley, in particular, who during his entire term of office labored zealously and intelligently for the betterment of business and credit conditions.

The Federal Reserve Board in prescribing a uniform Balance Sheet to be used for credit purposes has performed a real service in promoting uniform accounting.

In commenting on the model Balance Sheet prescribed, attention should be called to the fact that it would have been better to separate notes and accounts receivable so as to allow a separate deduction for a reserve for bad debts from each. The percentage of loss will not be so great on notes as on open accounts, therefore, the percentage set up as reserves will vary.

Note that securities are excluded from the list of "quick" assets, but included in the list of current assets. This is in accordance with Federal Reserve practice, but ordinarily no distinction is made between quick and current assets.

No provision for accrued assets is made. In practically every audit, there will be a certain amount of accrued assets. These should always be listed among the current assets and in using the form of Balance Sheet as advocated by the Federal Reserve Board, it is apparent that accrued assets would be listed under the heading of "Other quick assets." Since provision was made for accrued liabilities on the credit side, one is inclined to think that similar provision should have been made for accrued assets on the debit side.

The accounting student might easily be misled from the fact that fixed assets are all grouped together, followed by reserves for depreciation. It was undoubtedly the intention that the reserves for depreciation should be deducted from the particular fixed asset to which they are applicable. For instance, a reserve for depreciation on machinery is a deduction from the Machinery account on the Balance Sheet and not from the total fixed assets, even though the final results would be the same. Likewise, reserves for depreciation on buildings should be deducted from the asset, buildings. Reserve for depreciation on office furniture and fixture should be deducted from the asset, furniture and fixtures, and so on.

On the credit side of the Balance Sheet, there is to be noted a peculiar difference from the usual practice. The intangible asset, good will, is deducted from the net worth. It has been customary to list good will and other similar intangible assets on the asset side of the Balance Sheet separate from either current or fixed assets, usually at the bottom of the statement. While the final results are the same with either method, yet there is no doubting the fact that certain intangible assets, such as good will, may have a definite value, and in that event one can see no objection to their being listed as assets.

ASSETS.

Cash:			
1a. Cash on hand—currency and coin.		xxxxx.xx	
1b. Cash in bank.		xxxxx.xx	xxxxx.xx
Notes and Accounts Receivable:			
3. Notes receivable of customers on hand (not past due).		xxxxx.xx	
5. Notes receivable discounted or sold with indorsement or guaranty.		xxxxx.xx	
7. Accounts receivable, customers (not past due).		xxxxx.xx	
9. Notes receivable, customers, past due (cash value, $xx).			
11. Accounts receivable, customers, past due (cash value, $xxxx).		xxxxx.xx	
Less:		xxxxx.xx	
13. Provisions for bad debts.	xxxxx.xx		
15. Provisions for discounts, freights, allowances, etc.	xxxxx.xx	xxxxx.xx	xxxxx.xx
Inventories:			
17. Raw material on hand.		xxxxx.xx	
19. Goods in process.		xxxxx.xx	
21. Uncompleted contracts.	xxxxx.xx		
Less payments on account thereof. .	xxxxx.xx		
		xxxxx.xx	
23. Finished goods on hand.		xxxxx.xx	xxxxx.xx
Other Quick Assets (describe fully):			
. . . .		xxxxx.xx	
. . . .		xxxxx.xx	xxxxx.xx
			xxxxx.xx
Total quick assets (excluding all investments).			
Securities:			
25. Securities readily marketable and salable without impairing the business.		xxxxx.xx	
27. Notes given by officers, stockholders, or employees.		xxxxx.xx	
29. Accounts due from officers, stockholders, or employees.		xxxxx.xx	xxxxx.xx
Total current assets.			xxxxx.xx
Fixed Assets:			
31. Land used for plant.		xxxxx.xx	
33. Buildings used for plant.		xxxxx.xx	
35. Machinery.		xxxxx.xx	
37. Tools and plant equipment.		xxxxx.xx	
39. Patterns and drawings.		xxxxx.xx	
41. Office furniture and fixtures.		xxxxx.xx	
43. Other fixed assets, if any (describe fully).		xxxxx.xx	
. . . .		xxxxx.xx	
		xxxxx.xx	
Less:			
45. Reserves for depreciation.		xxxxx.xx	
Total fixed assets.			xxxxx.xx
Deferred Charges:			
47. Prepaid expenses, interest, insurance, taxes, etc.		xxxxx.xx	xxxxx.xx
Other assets (49).		xxxxx.xx	xxxxx.xx
Total assets.			xxxxx.xx

(Model Balance Sheet for credit purposes.)

LIABILITIES.

Notes and Accounts Payable:			
Unsecured Notes—			
2. Acceptances made for merchandise or raw material purchased		xxxxx.xx	
4. Notes given for merchandise or raw material purchased		xxxxx.xx	
6. Notes given to banks for money borrowed		xxxxx.xx	
8. Notes sold through brokers		xxxxx.xx	
10. Notes given for machinery, additions to plant, etc.		xxxxx.xx	
12. Notes due to stockholders, officers, or employees		xxxxx.xx	xxxxx.xx
Unsecured Accounts:			
14. Accounts payable for purchases (not yet due)		xxxxx.xx	
16. Accounts payable for purchases (past due)		xxxxx.xx	
18. Accounts payable to stockholders, officers, or employees		xxxxx.xx	xxxxx.xx
Secured Liabilities:			
20a. Notes receivable discounted or sold with indorsement or guaranty (contra)		xxxxx.xx	
20b. Customers' accounts discounted or assigned (contra)		xxxxx.xx	
20c. Obligations secured by liens on inventories		xxxxx.xx	
20d. Obligations secured by securities deposited as collateral		xxxxx.xx	xxxxx.xx
22. Accrued liabilities (interest, taxes, wages, etc.)		xxxxx.xx	xxxxx.xx
Other Current Liabilities (describe fully):			
....		xxxxx.xx	
....		xxxxx.xx	xxxxx.xx
Total current liabilities			xxxxx.xx
Fixed Liabilities:			
24. Mortgage on plant (due date)		xxxxx.xx	
26. Mortgage on other real estate (due date)		xxxxx.xx	
28. Chattel mortgage on machinery or equipment (due date)		xxxxx.xx	
30. Bonded debt (due date)		xxxxx.xx	xxxxx.xx
32. Other fixed liabilities (describe fully):			
....		xxxxx.xx	
....		xxxxx.xx	xxxxx.xx
Total liabilities		xxxxx.xx	xxxxx.xx
Net Worth:			
34. If a corporation—			
(a) Preferred stock (less stock in treasury)		xxxxx.xx	
(b) Common stock (less stock in treasury)		xxxxx.xx	
(c) Surplus and undivided profits		xxxxx.xx	
		xxxxx.xx	
Less:			
(d) Book value of good will	xxxxx.xx		
(e) Deficit	xxxxx.xx	xxxxx.xx	xxxxx.xx
36. If an individual or partnership—			
(a) Capital		xxxxx.xx	
(b) Undistributed profits or deficit		xxxxx.xx	
Total Liabilities and Net Worth			xxxxx.xx

(Model Balance Sheet for credit purposes.)

THE FOLLOWING DISCUSSION OF THE BALANCE SHEET IS BY JAMES O. McKINSEY, C. P. A.*

"**The Purpose of the Balance Sheet** is to make the financial facts in regard to the business COMPREHENSIBLE to the proprietor and others. This idea cannot be emphasized too strongly, not only in regard to the Balance Sheet, but also in reference to all the other financial statements. It should be remembered that they are prepared primarily for the proprietor or creditors of the business, and many of them have no technical training in accounting. These statements should be in such a form that they can be readily understood by those for whom they are intended. Mr. Montgomery says: 'Many intelligent people fail to grasp the usual conventional hypothesis underlying the theory of double entry bookkeeping, and, therefore, facts or figures presented to them in a technical or formal shape may not accomplish the intended result.'

Balance Sheet vs. Financial Statement. "Probably one of the first questions which arise in the mind of some readers is in reference to the propriety of the term 'Balance Sheet'. The writer is well aware that this term is not generally used in elementary accounting texts. The term 'financial statement' seems to be a favorite one with most text writers, although the terms 'statement of resources and liabilities,' 'statement of assets and liabilities', and 'business statement' are sometimes used. A financial statement is any statement of financial facts. The Balance Sheet is a financial statement, but so is a Profit and Loss statement, a statement of Affairs, or a statement of Receipts and Expenditures, as well as many others which might be added. To call this particular statement a financial statement does not differentiate it from many other such statements. In reference to the other terms mentioned, it is sufficient to say that they are rarely used by accountants, and when they are used, they are employed for a special purpose and not in reference to the statement which is defined as a Balance Sheet above. The writer has had occasion to examine numerous reports made by accountants of the highest rank, in three different large cities, during the last two years and he has never seen any term but Balance Sheet used in the above connection.

"As stated above, the purpose of the Balance Sheet is to set forth the financial condition of the business. This statement might be criticised on the ground that the true and complete financial condition is not shown unless the Balance Sheet is accompanied by the statement of Profit and Loss. In other words, it is impossible to intelligently judge of the present condition unless the causes of that condition and thereby some indication of the possibilities of the future are known. Leaving

* Instructor of Accounting at the University of Chicago. Author of "Bookkeeping and Accounting," published by South-Western Publishing Company.

aside this question for the present, it can be readily seen that the Balance Sheet should show three things:

1. The amount and nature of the assets.

2. The amount and nature of the liabilities.

3. The amount and nature of the differences between the assets and liabilities, which constitutes the interest of the proprietor.

"In order that this may be done satisfactorily, it is necessary that the accounting records be properly kept, so that the desired information may be obtained. This, of course, involves all the principles governing the proper construction of the different accounts. Assuming that the accounts are properly kept, the following will be confined to a brief discussion of the arrangement of the accounts on the Balance Sheet so that it will afford as much information as possible.

"Often no attempt is made to classify the assets and liabilities. They are arranged in no definite form or order, and their nature, other than by their name, is not indicated. It seems their only purpose is to state the amount of the items and the total thereof. This is, of course, essential, but since other important information can be given so easily, it seems desirable that some attention be given to the classification and arrangement of the accounts.

Classification of Assets and Liabilities. "The most simple, and at the same time the most important, classification of assets and liabilities is into the two classes: fixed and current. There are further divisions, but the above are the most important and are sufficient for elementary work in accounting.

"The two simple Balance Sheets given on page 44 illustrate the points previously discussed. The first illustration shows a Balance Sheet in the form frequently used. The second illustration shows the same Balance Sheet with the assets and liabilities classified as current and fixed.

"The headings of Balance Sheets are frequently omitted or stated incorrectly. The form shown here is the one employed by accountants in making Balance Sheets to submit with their reports. Only a few of the more elementary principles in regard to the Balance Sheet have been discussed here."

JOHN JONES

Balance Sheet June 30, 1919

Assets		Liabilities	
Cash	$ 900	Mortgages Payable	$ 2000
Notes Receivable	2000	Notes Payable	3000
Accounts Receivable	2800	Accounts Payable	2600
Merchandise Inventory	6000	John Jones, Capital	7500
Furniture & Fixtures	400		
Real Estate	3000		
	$15100		$15100

(Unclassified Balance Sheet)

JOHN JONES

Balance Sheet June 30, 1919

Assets				Liabilities		
Current Assets:				**Current Liabilities:**		
Cash		$ 900		Notes Payable	$3000	
Accounts Receivable		2800		Accounts Payable	2600	
Mdse. Inventory		6000		Total Cur. Liabilities		$5600
Notes Receivable		2000				
Total Current Assets			$11700	**Fixed Liabilities:**		
Fixed Assets:				Mortgages Payable		2000
Furniture & Fixtures		$ 400		Total Liabilities		$ 7600
Real Estate:						
Land	$1000			**Capital or Proprietorship:**		
Buildings	2000	3000				
Total Fixed Assets			$3400	Invest. June 30, 1919	$7000	
				Profits for the Year	500	
				Present Investment		7500
Total Assets			$15100	Total Liabilities & Prop.		$15100

(Classified Balance Sheet)

THE LAW OF CONTRACTS (Continued)

Contracts are not always valid. They may be illegal, void, voidable or unenforceable. The validity of a contract depends upon the law of the state in which it is executed. In case of a suit to enforce a contract, the laws of the state in which the suit is brought govern the remedy. If a contract is executed in one state and is delivered in another state, the laws of the state in which it is delivered govern the delivery.

Illegal Contracts are always void and have no standing whatever in the eyes of the law. Agreements to do anything contrary to law or agreements against the public policy are illegal and void.

A Voidable Contract is one in which one of the parties may legally refuse to carry out the agreement, but at the same time, if the injured party desires, the other party can be compelled to carry out the agreement. It will be seen that the law is protecting one of the parties, but not the other. An example is a contract made with a minor, an alien, an insane person, or an intoxicated person.

An Unenforceable Contract will not be enforced by courts if either party objects to its terms. Suppose A agrees to sell B his house and lot for $5,000.00 and B agrees, orally to buy. The contract is unenforceable because contracts to sell real estate must be made in writing, or at least there must be a memorandum in writing.

Mistakes. A Mistake of Fact exists when a mistake has been made as to whom one is contracting with, concerning the subject matter, or concerning the nature of the contract. When a mistake of fact exists the contract is void and cannot be enforced.

A Mistake of Law exists when a party misunderstands the legal effect of his word or acts. "Ignorance of the law excuses no one," therefore, a mistake of law is no cause for escape from a contract.

Fraud. Fraud is the wilful misrepresentation of material facts and if proven the contract becomes voidable.

Misrepresentation in the form of a mere expression of an opinion does not constitute fraud. When fraud is performed, the contract may be declared void at the option of the defrauded party, but can not be annulled by the one committing the fraud.

Alteration of a contract wrongfully, amounts to fraud and makes it voidable. This must not be misconstrued. If one were to be given a check properly signed and made out with the exception that the date was omitted, he would have the right of filling out what was understood to be the correct date. Likewise, if the amount was omitted, he might fill in an amount himself, and if he could show that it was the correct amount the check would be good. Do not sign contracts of any kind with any part of the terms blank. Be sure that they are properly filled in in detail.

A. THEORY QUESTIONS

1. What is the chief consideration in the arrangement of ledger accounts? C. P. A. Ind.

2. What is meant by Controlling Accounts? Give three illustrations of the use of such accounts. State the advantages of such accounts. C. P. A. Ohio.

3. Describe a method of keeping accounts so that the aggregate sums due from customers and due to creditors can be known without preparing a schedule of the accounts of such customers and creditors, and so that an independent balance of the ledger, containing only the real, nominal, special and controlling accounts, exclusive of the individual accounts of customers and creditors may be taken. C. P. A. N. Y.

4. Wherein does the Trial Balance differ from the Balance Sheet?

5. Would you, or would you not, be satisfied with a list run off on an adding machine by some one connected with the institution under examination after you had compared the amount of each item with the listed figures? Give your reason. C. P. A. Del.

B. ACCOUNTING PROBLEMS

1. For the six months ending June 30, 1916, the balances appearing on the books of George Parker are as follows:

Cash in bank	$ 4,765.14
Cash on hand	100.64
Capital, George Parker	17,821.04
Bills Receivable	6,164.92
Bills Payable	1,301.90
Debtors	20,903.88
Creditors	6,263.12
Purchases	255,642.42
Sales	266,723.40
Furniture and Fixtures	811.32
Drawing, George Parker	4,000.00
Discounts Received	8,824.22
Discounts Allowed	5,240.52
Expenses New York office	3,762.18
Expenses branch office	441.10
Expenses general office	553.52
Reserve for Bad Debts	1,451.96

Prepare Trial Balance and Balance Sheet. (No merchandise inventory).

2. A manufacturer is desirous of securing a partner and furnishes a statement covering five years' operations as follows:

ASSETS.

Buildings	$ 20,000.00
Machinery and Fixtures	75,000.00
Inventory, Mdse. and Supplies	50,000.00
Cash	5,000.00
Accounts Receivable	40,000.00

LIABILITIES.

Accounts and Bills Payable	$ 30,000.00

Sales average per year	$500,000.00
Wages paid per year	170,000.00
Expense, Selling and General, per year	35,000.00
Material purchased	260,000.00

Buildings are on leased ground, lease expires in ten years, annual land rental, $1,000.00. Buildings revert to owner at expiration of lease.

New machinery when installed ten years ago cost $50,000.00. Additions since cost $25,000.00. No depreciation has been charged off. All repairs and replacements charged to expense.

What in your opinion would be a fair price to be contributed for a half interest? Explain fully. C. P. A., Mich.

(Note. In connection with this problem you may assume that upon investigation you ascertained the following facts:

(a) That the accounts receivable are guaranteed to be collectible, hence no reserve on account of doubtful accounts need be made.

(b) That the inventory of merchandise and supplies was priced at cost and that the accuracy of the items listed was tested and found to be accurate.

(c) That the buildings are so constructed that at the expiration of the lease they will have no residual or scrap value, hence a reserve for depreciation of 5% per annum for the past ten years should be calculated and a further reserve of 5% per annum should be set up during the remainder of the lease.

(d) That at least 5% depreciation per annum for ten years should be calculated on machinery costing $50,000.00, and the same rate per annum for a period of five years on new machinery costing $25,000.00. It is estimated that the machinery will continue to depreciate at a rate of 5% per annum.

(e) That all the liabilities are stated and that there are no contingent liabilities.

(f) No valuation need be placed on good will.

Submit a statement showing how you arrived at the value of a half interest).

C. LEGAL QUESTIONS

1. Distinguish between a Mistake of Fact and a Mistake of Law.

2. What makes a contract illegal? C. P. A. Mich.

3. What is the difference between fraud and misrepresentation? C. P. A. Ohio.

4. Define or describe, void, voidable and unenforceable contracts. Inst. Ex. 1917.

5. A contract executed and delivered in California is the subject matter of a suit in New York. What laws will govern the validity of the contract, and what laws will govern the remedy? State the rule in such cases. Inst. Ex. 1917.

Chapter Four

(NOTE.—As a student of accounting, you will want to become familiar with the practical side of public accounting and auditing, and in order that you may best do this, the actual procedure of a Balance Sheet audit will be discussed in the following chapters. It will be taken up in such a manner that you will have an opportunity to observe the work of both junior and senior accountants).

The correspondence shows that the name of the client is The Blank Manufacturing Company. (See Engagement Blank, page 18, for details.) A firm of accountants has been employed by the Board of Directors to make a Balance Sheet audit as at the close of business December 31, 1918, principally for credit purposes, but also to establish whether there have been any errors of principle on the part of the chief accountant of the Company, who planned the system of accounts in use, and who heretofore has prepared all financial statements. Each accountant has been furnished with a letter of introduction and the usual auditor's equipment. The senior in charge is an experienced man who understands how to direct the work of a number of juniors and has full authority for deciding all questions relative to procedure and accounting principles. Two juniors are assigned to work with the senior. The juniors understand that when they are in doubt relative to any part of the work, or if they discover anything that is not clear to them, they are to report immediately to the senior for instructions. A full set of working papers must be kept by each accountant relative to the work completed by him. When the audit is completed the senior will arrange all working papers in order and make a report to the managing senior, who will prepare therefrom final reports which will be submitted to the client.

On reporting at the general office of The Blank Manufacturing Company on January 15, 1919, and being properly introduced to Mr. L. W. Shields, general manager, Mr. Harold Pond, chief accountant, and the heads of departments, the senior is given a Trial Balance taken from the general ledger, and other information as follows:

Trial Balance, Dec. 31, 1918.

Cash	$ 20,162.00	
Cash deposited for dividend No. 9	2,050.00	
Cash deposited for bond interest	2,500.00	
Land	100,000.00	
Buildings	150,000.00	
Machinery	100,000.00	
Tools and implements	20,215.00	
Horses, wagons and harness	15,000.00	
Office furniture	2,600.50	
Notes receivable	12,906.00	
Accounts receivable	81,687.00	
Sinking fund	15,000.00	
Investment of surplus	10,000.00	
Salary advances to salesmen	980.00	
Unapportioned organization expense	7,350.00	
Bond discount unamortized	6,000.00	
Div. No. 9, 5% authorized 7–1–18	22,500.00	
Good will	75,000.00	
Unsubscribed stock	50,000.00	
Notes payable		$ 21,000.00
First mortgage 5%, 20–yr. bonds		100,000.00
Accounts payable		51,780.50
Due to officers and clerks		7,681.50
Bond interest coupons due		2,500.00
Div. No. 9, vouchers outstanding		2,050.00
Res. for baddebts, less $970 written off		56.00
Res. for depr. on buildings, 2½%		2,500.00
Res. for depr. on machinery, 6%		9,000.00
Res. for dep. on horses and wagons, 10%		1,500.00
Capital stock, 5,000 shares at $100		500,000.00
Sinking fund reserve		15,000.00
Sales less returns and allowances		625,275.00
Rent of part of business premises		250.00
Inventory 12–31–17, raw material	37,310.50	
Inventory 12–31–17, finished stock	15,000.00	
Purchases	195,000.00	
Factory pay roll, labor	300,200.00	
In-freight and cartage	2,831.00	
Office salaries and clerical force	37,560.00	
Salaries of salesmen	30,220.00	
Advertising	25,150.00	
Taxes paid	2,010.00	
Insurance	1,300.00	
Bond interest	5,000.00	
Interest and discount	3,250.00	
Stable expense	2,000.00	
Office and other expense	12,875.00	
Maintenance and repairs	13,471.00	
Surplus, 12–31–17		38,535.00
	$1,377,128.00	$1,377,128.00

Inventory, Dec. 31, 1918:

Finished stock	$80,000.00
Materials and stock in process	55,000.00
Factory pay roll accrued but not paid	2,875.00
Unexpired insurance	456.00
Interest accrued on invested surplus	126.32
Interest accrued on sinking fund	875.34

The senior ascertained from the general manager and the chief accountant the following additional information:

1. It is desired to set aside the same reserve for depreciation as at the end of the previous year.
2. The practice of the Company has been to charge off 10% of the balance of organization expense annually and they prefer to continue this policy.
3. The account with bond discounts is being charged off at the rate of 5% annually.
4. It is estimated that 2% of notes and accounts receivable will prove to be worthless.
5. An appropriation of $15,000 is to be made to the sinking fund and the cash from same to be placed in the hands of a trustee at the completion of this audit.
6. The balance of profits available for distribution is to be shown as a credit to undivided profits or surplus.

The chief accountant furnishes the senior upon request with a list of the books of account as follows:

Books of Original Entry:

(a) General journal.
(b) Purchases book.
(c) Purchases returns book.
(d) Sales book.
(e) Sales returns book.
(f) Cash receipts book.
(g) Cash payments book.
(h) Notes receivable book.
(i) Notes payable book.

Ledgers. In addition to the general ledger, there is kept subsidiary ledgers with customers and with creditors.

CASH

The senior having prepared an audit program, directs one of the juniors to proceed with the count of cash and the verifying of the cash and bank balances.

1. ACCOUNTING THEORY

The Theory of the Cash Account. This account is usually kept with more care than any other account, though it is difficult to understand why a business man should safeguard his cash with any greater degree of care than other assets representing money's worth or cash value. If as great precaution were used in the keeping of accounts with merchandise as is used with cash, there would be much less temptation for

fraud, theft, etc. The average business man is satisfied to take a physical inventory of merchandise once a year, but counts his cash daily.

Accountants advocate the keeping of an account with cash in the general ledger. It partakes of the nature of a controlling account since it is debited only with the total receipts and credited only with the total payments at the end of each designated period, usually at the end of each month. Many bookkeepers keep only a cash book and do not keep an account with cash in the general ledger. The bookkeeper simply refers to the cash book for the cash balance when preparing the Trial Balance. The general ledger is supposed to balance, independent of all the other books of account, but will not do so unless an account is kept with cash.

Several forms of cash books will be found in use. They have been devised for all sorts of reasons and to meet all kinds of conditions. They run the scale from a cash book with only a general column on each side to a complicated form of cash journal containing all the transactions, either individually or in summary. Then, too, the cash book will be found divided, one being kept for receipts only and another for payments. This division enables two bookkeepers to work on the cash books at the same time, one handling receipts and another handling disbursements. This is an advantage in large concerns, and there is also less chance for embezzlement. In some cases a separate cash book is kept for recording receipts from trade customers only, or one for recording payments to trade creditors only.

Imprest System. Since it is important that all receipts be deposited in the bank and all payments be made by check, there has come into use what is known as the PETTY CASH FUND or IMPREST SYSTEM.

A certain sum is drawn from the bank by writing a check payable to Petty Cash, the proceeds of which is placed in the care of a petty cashier whose duty it is to pay out small sums below a certain amount. An account is kept with Petty Cash and at certain periods the cashier presents a record of his disbursements supported by vouchers and the fund is replenished. There are slightly different methods in handling the Petty Cash and the different methods should be thoroughly understood.

J. W. Baker,* in discussing the Petty Cash Fund, writes:

> "All cash received should be deposited, and all payments made by check. If it is necessary to make small payments, these should be made from a fund kept on hand for this purpose. This fund is known as the 'Petty Cash Fund' or 'Imprest Fund'. It is created by withdrawing from the bank an amount sufficient to meet these payments. This may be $10.00, $20.00,

*20th Century Bookkeeping and Accounting.

$50.00, or $100.00, according to the amounts required. The check needed to establish the fund is entered in the general cash book, the same as other checks, the amount being debited to a Petty Cash Fund or Imprest Fund account in the general ledger. When the fund has been exhausted by the payments, another check is drawn for the amount necessary to replenish the fund. At this time the proper accounts are charged in the general cash book for the payments from the petty cash fund. The amount (balance of the Petty Cash Fund account) remains the same until the account is closed, which would be at the end of the fiscal period, or when the imprest system is discontinued."

Fraud. The professional auditor learns from experience that there are certain methods whereby a bookkeeper may dishonestly abstract funds of a company and still keep his books and accounts in balance. The following are a few of the more common methods which an auditor should always be able to detect during the course of a professional audit:

1. The bookkeeper may withhold a part of the cash receipts and make no entry whatever on the books of account, neither recording the receipt of cash nor the credit to the customer's account.

2. The bookkeeper may withhold a part of the cash received and instead of recording it as a cash receipt may credit the customer for an allowance on returned goods.

3. After the cash has been entered in the cash book and properly posted to the correct account, the bookkeeper may alter the cash book footings so that they will show a smaller amount of receipts or a larger amount of payments and then withhold cash equal to the amount of the difference.

4. The bookkeeper may withhold a part of the cash receipts making no entry in the cash book, but may enter directly in the ledger a credit to the customer's account, and, at the same time, make a fictitious debit to some other customer's account in order to keep the ledger in balance.

5. The bookkeeper may pay cash to offset some invoice previously entered fraudulently, the invoice having been charged to some expense account. Of course, the bookkeeper would abstract the cash thus paid and make the proper entry on the credit side of the cash book.

6. A sale to a customer on account may not be recorded at all and when the cash is received the bookkeeper simply withholds it, making no entry therefor.

7. A process of "overlapping" may be resorted to. In this way the bookkeeper may withhold cash as received and substitute therefor subsequent receipts of cash as they come in. This is kept up continuously so as to cover the original discrepancies.

Suggestions to Eliminate Possibility of Fraud. If the system for handling the cash and cash items, and for keeping the accounts and records in connection with cash is properly planned, possibility of fraud may be largely eliminated. The policy of internal check should be carefully followed. The following general suggestions will aid materially in planning the system of accounts and the system of internal check so as to prevent fraud in connection with the handling of cash:

1. Do not permit the bookkeeper who keeps the personal accounts to act as cashier. The one who records the receipts and payments of cash in the cash book should not have access to the customers' and creditors' ledgers.

2. The entire cash receipts must be deposited in the bank regularly—daily if convenient. When this plan is carried out, the cash receipts will be exactly equal to the deposits in the bank during any month or during the entire fiscal period.

3. All disbursements must be made by check. This does not mean that petty disbursements cannot be made in cash. The petty cash fund can be created and replenished from time to time by check and the petty cashier should be required to account for all disbursements of whatever nature by properly signed vouchers.

4. The check book should be in the custody of the one who signs the checks. This will usually be the cashier. The bookkeeper should not have access to the check book.

The suggestions above will not in themselves prevent the fraudulent withholding of cash and failure to properly record receipts, neither will they prevent "overlapping." This can be overcome to a certain extent by arrangements whereby the cash receipts are handled by more than one person. For instance, a list of the cash receipts may be made at the time the mail is opened. The cash and cash items are then given to the cashier for recording and for deposit. In this way, two different persons are charged with the handling of the cash receipts. The bookkeeper may post to the customers' accounts direct from the list, or from the cash book. At any rate, the list of cash receipts should go to an officer of the company who can later compare

the total receipts with the total deposits. If customers are billed regularly, any who have not been given credit for the full amount of their payment would be certain to enter a complaint. It will be seen that the object of any arrangement similar to this is to inaugurate an internal check. So much depends upon the volume of business that it is difficult to outline a set of rules; in fact, it would not be good policy to attempt to do so, because a system that would constitute a good internal check in one business, would not necessarily prove satisfactory in another.

2. AUDITING THEORY

Counting the Cash. This should be done at the close of business and on the last day of the period under audit if possible. However, it more frequently happens that the audit takes place subsequent to the close of the accounting period, therefore, it is best to count the cash on the first day of the audit at the close of business.

Some advocate that it is best to permit the person who is in charge of the cash to handle it and do the actual counting for the reason that he is, as a rule, skilled in the handling of cash. Another reason for it is that if the auditor does not handle the cash in person, he avoids the possibility of becoming involved in any irregularities. In case the cashier or person in charge of cash is permitted to count it, the auditor must, of course, supervise the count with the greatest care.

In counting the cash, the auditor must ascertain that all customer' checks, produced as a part of the cash balance, have been properly entered in the cash book prior to the close of business on that date, and should note the dates and descriptions of such checks as well as the dates and descriptions of such advances made of cash and not recorded on the books. Any advances to employees should be carefully investigated, and if they are secured by personal checks the auditor should see that the checks are certified by the bank on which they are drawn before the close of the audit.

Any unusual cash items, such as I. O. U.'s, should be carefully listed for investigation. However, the auditor should not adopt an attitude with regard to such matters that will react against him. If an employee owes an item of a few cents because he could not make change, it is not necessary to take the matter up with the head of the department or the president of the company. It is expected that anyone competent to act as either a junior or senior auditor will be able to use the proper discretion in such matters. One will frequently find bad coins that have been taken in unknowingly. These, of course, must be taken into consideration, but it does not justify criticism or fault-finding. Do not adopt the attitude of a detective.

Verifying the Bank Balance. Certificates must be obtained from the various banks in which accounts are maintained, as at the close of business, on the same day that the cash balance is counted, preferably on the last day of the fiscal period. If this is not possible, then on the first day of the audit. This is done by presenting to the banks a request signed by the depositor or his agent asking for a certificate showing the balance on a certain date. This certificate should be mailed to the auditor, not to the depositor.

Reconciling the Bank Certificate. This is done by checking the deposits with the cash book and vouching the payments with the cancelled checks. The bank balance will naturally vary from the cash book balance on account of checks outstanding. The outstanding checks should be listed for future reference. Where several banks are used as depositories, this becomes more complicated, but the general plan of procedure is the same. Having made a list of the checks outstanding, these may be investigated before the audit is completed, when it will likely be found that most of them have been presented to the bank for payment. Any still outstanding should be especially investigated.

"Kiting" Checks. It is well to be familiar with the process commonly known as the "kiting of checks". This can be detected by checking in detail the deposits of the last few days of the fiscal period and comparing with the receipts in the cash book. If a check drawn on one bank by the Company was deposited in another bank without being credited to the bank on which it was drawn prior to the close of the fiscal period, a false balance would be established. Be sure that a check drawn on one bank and deposited in another bank is properly entered.

Since it is considered the better practice to deposit all receipts in the bank, it is well to obtain some of the old deposit tickets and compare them with the cash receipts in the cash book to determine whether or not the cash receipts were properly deposited. This can also be determined by comparing the total deposits for any certain period with the total cash receipts of the same period.

Working Back the Cash. Usually an audit is made some days after the close of the period. This necessitates the counting of cash on a later date and working back to the day desired. After the exact cash balance has been determined on the date of audit, add the disbursements and deduct the receipts and the balance for the date desired will be obtained. This should be compared with the cash book balance on the date of the close of the fiscal period.

To illustrate this procedure:

March 10, 1919, balance per cash book.	$12,380.24
Add disbursements, since Dec. 31, 1918.	6,205.18
	$18,585.42
Deduct receipts since Dec. 31, 1918....	4,756.98
Balance, Dec. 31, 1918, end of period...	$13,828.44

3. AUDITING PROCEDURE

The junior assigned to count the cash and verify the bank balance, proceeded by first making a count of the cash on hand. His working papers show (see illustration on page 58) the result of his count. Among the checks, there was one signed by C. P. Cooley, which has been returned from the bank, marked "No funds". Investigation showed that shortly before the auditor began counting the cash the bank had returned the check, the cashier having settled by writing a new check payable to the bank for the proper amount, $17.76. This check, however, had not been entered in the cash book. After talking it over with the cashier, the proper entry was made, charging the amount back to the customer's account, and the check was not included in the cash balance.

Verification of the cash receipts book and cash payments book footings showed for the first fifteen days of January:

Receipts	$36,994.89
Payments	31,402.08
Excess receipts	5,592.81

According to the Trial Balance, the cash balance on Dec. 31, 1918, was $20,162.00. Adding to this the excess receipts for the first fifteen days of January, 1919, it will be seen that the cash balance at this date should be $25,754.81. The count of cash on hand shows a balance of $4,971.70. Therefore, there should be a balance in the bank at this time of $20,783.11 after deducting the sum of all outstanding checks.

Bank Certificate. The senior mailed a letter to the bank requesting a certificate showing the balance to the credit of the Blank Manufacturing Co., at the close of business on January 15, 1919. It is customary with banks to furnish this information, but it is first necessary to have your request approved by the client. Banks do not like to give out information without the permission of the depositor.

The bank responded with a certificate showing a balance on January 15, 1919, to be $28,950.50, divided into three funds,

General checking account	$24,400.50
Fund for Dividend No. 9	2,050.00
Fund for Bond interest	2,500.00

The bank also returned to the Blank Manufacturing Co. the canceled checks.

After obtaining the bank certificate and the canceled checks the junior continued his work by reconciling the bank balance. (See illustration on page 59.)

He found that the following checks had been issued but had not as yet passed through the bank:

No.	Date.	Payee	Amount.
4527	12/ 8/18	Flint & Walling Mfg. Co.	$ 765.80
4597	1/ 5/19	A. S. Morrow & Co.	1,499.10
4599	1/ 7/19	Geo. A. Barns	75.00
4670	1/10/19	L. W. Kindow	985.00
4682	1/14/19	Robert E. Arnes & Son	292.49
			$3,617.39

Cash count: THE BLANK MANUFACTURING CO. C. E. Shaw, Junior

	Jan. 15, 1919--5:30 P. M.	E. E. Oates, Cashier.					
	Bills:						
25	$20	$500	00				
30	10	300	00				
40	5	200	00				
10	2	20	00				
80	1	80	00	$1100	00		
	Gold:						
10	$20	200	00				
4	10	40	00				
4	5	20	00	260	00		
	Silver:						
6	$ 1	6	00				
35	.50	17	50				
33	.25	8	25				
23	.10	2	30				
14	.05		70				
41	.01		41	35	16		
	Total cash on hand					$1395	16
	Cash items:						
	Checks						
	Jan. 11 C. P. McGerry	75	29				
	13 P. E. Admire	154	00				
	14 A. E. Mandeck	23	93				
	10 G. W. Gerring	87	60				
	6 E. H. Lehman	1	50				
	15 H. E. Biddinger	123	90				
	9 S. J. Musick	156	00				
	8 W. A. Wirtz	321	80				
	14 C. W. Jones	1280	10				
	12 C. C. White	1347	86	3571	98		
	Miscellaneous						
	P. O. Money Order W. W. Ward	1	60				
	Express Money Order J. E. Joiner	2	96	4	56	3576	54
	Total cash					4971	70

(A1–Working Sheet, C. E. Shaw, junior accountant. Photographed and reduced one-half.)

The junior ascertained the following additional facts:

(a) That the footings of the cash book were in ink.

(b) That it was the custom of the company to make a deposit each day at noon.

(c) That the cash on hand represented receipts since the last deposit was made at noon, Jan. 15, 1919.

(d) That this deposit was shown in the bank certificate.

(e) That the checks listed had all been entered in the cash receipts book.

(f) That the check written in favor of the bank on Jan. 15, 1919, on account of the check returned by the bank with the notation, "no funds", had been deducted from the balance as shown on the certificate.

THE BLANK MANUFACTURING CO.

(a) Verification of cash book balance
(b) Reconciliation of Bank balance

C. E. Shaw,
Junior

Completed Jan. 16, 1919						
Balance (Jan. 15, 1919) as per bank certificate attached hereto			$28950	50		
Deduct						
Fund for Dividend No. 9	$2050	00				
Fund for Bond interest	2500	00	4550	00		
Balance in general checking account					$24400	50
Deduct checks in transit:						
No. 4527	765	80				
4597	1499	10				
4599	75	00				
4670	985	00				
4682	292	49			3617	39
Available balance in bank					20783	11
Add cash on hand (see record of count attached)					4971	70
Cash balance Jan. 15, 1919					*25754	81
WORKING BACK:						
Add disbursements (Jan. 1 to 15)					31402	08
					57156	89
Deduct receipts (Jan. 1 to 15)					36994	89
Cash balance Dec. 31, 1918					20162	00
Total cash receipts book, Jan. 15, 1919			36994	89		
Total cash payments book, Jan. 15, 1919			31402	08		
Excess receipts			5592	81		
Add C. B. balance Dec. 31, 1918			20162	00		
C. B. balance Jan. 15, 1919			*25754	81		

(A2–Working Sheet, C. E. Shaw, junior accountant. Photographed and reduced one-half.)

THE LAW OF CONTRACTS (Continued)

Assignment of Contracts. Contracts which do not depend on personal service, skill, ability, or trustworthiness of one or all of the parties involved may be assigned by either of the parties. Of course, if one of the conditions in a contract forbid its assignment, it could not be assigned. Assignments should be in writing, whether the contract is an oral or a written one. If it is a written one the assignment can be made on the back of the contract, and if it is an oral one the assignment can be made in writing anyway. A contract governed by the Statute of Frauds must be assigned in writing. However, there is nothing to prevent the assignment of contracts not governed by the Statute of Frauds by "word of mouth" or by "delivery".

The assignee becomes liable to perform all the duties of the party who assigns the contract and receives only such rights as the original party enjoyed. His title is no better than that possessed by the original party. If the other parties possessed any defenses against the assignor, they possess the same defenses against the assignee. By defenses is meant fraud, duress, undue influence, offset, etc.

Novation. A novation is the substitution of other parties, or another party, not originally bound by the contract, for one of the original parties to the contract. This can be accomplished only by agreement of all the parties concerned.

Discharge. There are five principal means of discharging contracts:

1. By performance.
2. By agreement.
3. By operation of law.
4. By intervention of impossibility.
5. By breach of contract.

Performance. This is the simplest method of discharging contracts and it is the usual way. When all parties to a contract have fulfilled their agreement in full, the contract is discharged.

Agreement. By mutual agreement, all the parties to a contract may set it aside, thereby discharging it. However, this agreement is simply another contract and must conform to all the conditions of a legal contract. Usually there is simply an oral agreement that the contract be discharged, that is, a mutual understanding of all the parties concerned. It should be definitely understood, and in some cases, it would be best to put it in writing.

Operation of Law. A contract may be discharged by the making of a new contract. Usually this is one of a higher order. A written agreement discharges an oral agreement and an agreement under seal discharges a simple contract in writing. Practically all contracts are discharged by bankruptcy. Taxes, judgments, alimony allowances, and debts created by fraud, embezzlement, misappropriation, or defalcation while in charge of a trust are exceptions to the rule of discharge by bankruptcy. Death discharges executory contracts for personal service in which skill and taste are involved.

Intervention of Impossibility. A contract to do something that was impossible from the beginning is void. It is best, however, to make provision in the contract for strikes, war, acts of God, etc. By "acts of God" is meant floods, tornadoes, hurricanes, public calamities, etc.

Breach of Contract. Violation of the terms of a contract is called a breach of contract. The innocent party to a contract may be discharged from further liability if the other party fails to do something which he agreed to do or does something which he agreed not to do. If the breach is such that the innocent party is not discharged from his obligations, he will be entitled to either money damages or to the right of "specific performance".

A court may compel a party to a contract to do as he agreed to do or to perform all the terms of the contract. This is known as a "specific performance."

A Tender is an offer to pay. A tender of payment or an offer to perform the conditions of a contract does not discharge the contract. One may avoid penalty for non-payment, court costs, and interest on the debt from the time of the offer by making a tender; but he must hold himself ready to pay or perform the conditions. In case the offer to pay is made in money, it must be made in legal tender.

Legal Tender is that currency or money which the law authorizes a debtor to tender and requires a creditor to receive in payment of money obligations.

All gold coins of the United States are a legal tender in all payments at their nominal value when not below the standard weight and limit of tolerance provided by law for the single piece, and when reduced in weight below such standard of tolerance, they are a legal tender at valuation in proportion to their actual weight.

Treasury notes and standard silver dollars for all payments.

Silver coins of a smaller denomination than one dollar for all sums not exceeding $10.00.

Nickels and pennies for sums not exceeding 25c.

Notes of the United States for all debts, public and private, except duties on imports and interest on the public debt.

Gold certificates payable to bearer were made legal tender under a Senate bill passed by the House December 19, 1919, and signed by the President.

The following chart is intended as a general review of contracts and should be carefully studied.

Contracts
- 1.—As to Essentials
  - 1.—Competent parties
  - 2.—Mutual agreement
  - 3.—Sufficient consideration
  - 4.—Legal subject matter
  - 5.—Compliance with Statute of Frauds.
- 2.—As to Solemnity
  - 1.—Under seal—Parol
  - 2.—Simple
    - 1.—Written
    - 2.—Oral
    - 3.—Implied
- 3.—As to Validity
  - 1.—Valid
  - 2.—Void
  - 3.—Voidable
  - 4.—Unenforceable
- 4.—As to Effects
  - 1.—Mistakes
    - of Facts
    - of Law
  - 2.—Fraud
  - 3.—Duress
  - 4.—Undue influence
  - 5.—Alteration
- 5.—As to Discharge
  - 1.—By performance
  - 2.—By agreement
  - 3.—By intervention of impossibility
  - 4.—By operation of law
  - 5.—By breach

A. THEORY QUESTIONS

1. If in the examination of the accounts of a merchant, the balance shown in the bank, or the balance as certified by the banker, agreed with the balance as disclosed on the merchants' cash book, would you consider any further examination necessary? C. P. A. Ind.

2. The cashier of a firm had disappeared. The cash book is left written up and balanced off, the custom being to pay any cash balance into the bank each day. What course would you pursue to ascertain whether there were any defalcations.
C. P. A. Mich.

3. Name some of the advantages of the use of additional columns in the cash book. C. P. A. Ohio.

4. If the actual cash on hand at the date of the Balance Sheet had not been verified by the auditor on the day of balancing, what method should be employed to prove the correctness before signing or certifying the statements. C. P. A. N. Y.

5. You are required to make a detailed cash audit for three years ending October 31, 1917. You find a disbursement for "Rent October, 1914, $1,000.00" on November 6, 1914. You are told the receipt is missing and the duplicate cannot be obtained. You are shown as a voucher a check dated November 6, 1914, payable to the landlord or order for $1,000.00, endorsed with a rubber stamp and marked by the client's bankers "paid".

State with your reasons whether you would accept this as sufficient evidence that the payment was made as recorded and, if not, what course you would adopt. Inst. Ex. 1917.

B. ACCOUNTING PROBLEMS

1. The result of your count of the "Cash on Hand" at a large agency on January 1, 1912, discloses:

Bills		$1,979.00
Coins		484.19
Cash items supported by properly signed vouchers:		
Jan. 14, 1908, Sub-agent Jones	$200.00	
July 20, 1909 " Thomas	140.00	
Aug. 20, 1909, " Vincent	75.00	
Sept. 30, 1910, " Nelson	230.00	645.00
Cash balance as per general ledger		$3,108.19

Does this count complete your duty as an auditor? If you consider that further steps are necessary, state what you would do. C. P. A. La. and Ore.

2. The cash book of a general trading concern shows for the month of January, 1912, the following:

1912		RECEIPTS	
Jan.	4	Collections from customers	$ 2,818.62
	7	do	1,147.33
	10	do	1,064.87
	13	do	1,232.55
	16	do	1,463.24
	23	do	2,417.14
	26	do	1,283.84
	29	do	1,543.62
	31	do	1,054.27
		Total receipts per cash book	$13,925.48

DISBURSEMENTS

Jan.	1	Overdraft on Bank	$ 10.32
	3	Sundry checks	2,153.27
	7	do	1,427.83
	11	do	926.84
	15	do	853.87
	19	do	428.32
	23	do	647.83
	29	do	2,437.38
	31	Balance as shown by cash book	5,029.82
			$13,925.48

Cash on hand undeposited amounted to $56.33.

A Petty Cash Fund is operated on the Imprest system.

The books had been audited to the 31st of December, 1911, and the fact established that the overdraft of $10.32 was correct, after all checks drawn had been presented and paid by the bank.

The deposits in the bank for the month of January, as shown by the bank pass book, after having it balanced at the close of business January 31, amounted to $13,854.37, and the checks returned by the bank for the same period totaled $8,832.34.

There were checks outstanding at the time of balancing, January 31, amounting to $53.27.

Fraud is suspected on the part of the cashier, and you are asked to check the transactions recorded by him as shown by the cash book. Prepare a statement showing the results of your investigations. Your statements should show total amount of the discrepancy. Also state, with reasons, what further documents and records you will require, if any, to trace the cash transactions fully. C. P. A. Ohio

C. LEGAL QUESTIONS

1. Enumerate the methods by which contracts may be discharged. C. P. A. Ohio.

2. What is your understanding of the term "Legal Tender"? Having defined this, state what falls within that designation in this country. C. P. A. Ill.

3. What is a tender to perform a contract, and what is its effect? Inst. Ex. 1918.

4. Give an illustration of a debt or claim that is not dischargeable in bankruptcy. C. P. A. Mich.

5. In what way may a contract be discharged by operation of law? Inst. Ex. 1918

Chapter Five

NOTES RECEIVABLE

Having completed the audit of the Cash account, the next account to be taken up is Notes Receivable. Notes are easily convertible into cash, consequently should be audited on the same day that the Cash account is audited.

1. ACCOUNTING THEORY.

There are two methods of recording notes and drafts receivable. The first method is to record them in the general journal and to keep a record in an auxiliary notes receivable book. Under this plan the notes receivable book contains a memorandum record only and does not constitute a posting medium. The notes receivable book should show the date received, drawer or endorser, maker or drawee, payee, where payable, due date, amount, rate of interest, and when paid.

The second method is to record notes and drafts in a notes receivable book from which posting is to be done. In other words, when this method is followed, the notes receivable book is considered a book of original entry and no auxiliary record is kept. This book differs from other subdivisions of the journal in that it provides for considerably more information. All the information provided for in the auxiliary notes receivable book explained above, is also provided for under this plan, and in addition, columns are provided to enable the bookkeeper to post the totals to the proper accounts in the ledger. The exact arrangement of the columns will depend upon the system of accounts in use. The notes receivable book will usually provide for a Notes Receivable debit, Interest debit, Interest credit, Sales Ledger credit, General Ledger debit and General Ledger credit columns. The important thing is to understand the two different methods of recording notes and drafts. If recorded in the general journal, then the entries should be supported by memorandum entries in an auxiliary notes receivable book. If a special division of the journal is to be used for recording transactions involving notes receivable, then all necessary information may be recorded in it and posting may be done direct from it.

Notes Receivable Account. If the first method explained above is followed, then the Notes Receivable account will show the individual debits and credits for each note receivable recorded in the books of account. If the second method is pursued, then the Notes Receivable account will be in the nature

of a summary or controlling account. For instance, the Notes Receivable account will be debited only for the total of the notes receivable debit column in the notes receivable book and may be credited for the total of the notes receivable column in the cash book, depending upon whether or not a special column for notes is provided on the debit side of the cash book.

Terminology. The term "bills receivable," is frequently used instead of "notes receivable", but it is practically universal in practice to records, notes and bills or drafts in the same account. Some bookkeepers call the account "bills receivable" while others call it "notes receivable". The term "bills" comes from the use of drafts and bills of exchange. There is no real object in attempting to separate drafts and notes in the books of account and, to do so, will only lead to confusion. A draft accepted by a customer is a "promise to pay" just as much as a promissory note would be. Seymour Walton, * C. P. A., says:

> "While the term 'bills receivable' is almost universally understood, it would perhaps be better if it could be replaced by the more accurately descriptive term 'notes receivable', on the ground that in this country, when a person gives his written promise to pay a given amount, the document is invariably referred to as his note, while a bill is the creditor's statement in writing, specifying the amount and character of his claim in detail".

Trade acceptances are becoming quite popular with business men. The question often arises as to whether or not a separate account should be kept with trade acceptances. In other words, should they be separated in the books of account from notes receivable. There can be no real reason for separating them in the ordinary business except where the volume of trade acceptances is large and it is desired to show trade acceptances as a separate item in the statements. In this event, separate accounts can be kept with trade acceptances and they may be recorded in the general journal, or a special journal may be provided.

Notes Receivable Discounted. A question arises as to the best method of recording notes receivable discounted. With a great number of bookkeepers, it is common practice to credit the Notes Receivable account at the time of discounting a note. This has been criticised by accountants because of the fact that before a note can be discounted it must be endorsed, and in case the maker fails to pay the note at maturity, the endorser becomes liable, consequently, accountants hold that this liability must appear in the statements. It is considered better practice to keep a separate account with Notes Receivable Discounted, crediting the account for the face value of each note or draft when discounted at the bank and debiting it with the

*From his text on "Auditing", published by the Alexander Hamilton Institute.

face value of each note or draft discounted, when paid or dishonored by the maker or payee. Of course, when the Notes Receivable Discounted account is debited, the Notes Receivable account would be credited. In order to verify the amount of notes receivable on hand, it is necessary to deduct the balance of the Notes Receivable Discounted account from the balance of the Notes Receivable account.

Contingent Liability. Notes receivable discounted are a contingent liability and this fact should be indicated in the Balance Sheet. Kester says:

> "For this reason, whenever a business house transfers a note by any method of endorsement (except the qualified), it incurs a contingent liability, which might become a real liability in case the maker of the note should fail to meet the obligation at maturity. Since it is the function of good accounting to present all the facts bearing on the welfare of the business, it is evident that this fact—that of incurring a contingent liability—should be entered in the books of account. Very frequently, however, the importance of this matter is practically ignored, with the result that the contingent liability item is lost sight of altogether."

2. AUDITING THEORY

It is important that the notes be counted on the same day that the cash is counted for the reason that, like cash, they may move on account of their being readily convertible. Analysis paper is usually used for preparing a list of notes receivable, on account of the amount of information desired.

Listing the Notes Receivable

(NOTE—Since this comprises a Balance Sheet audit for credit purposes, we will quote freely from the Federal Reserve Bulletin of April 1917. That Bulletin was termed "Uniform Accounting" and was intended as a tentative proposal to be adopted by manufacturing and merchandising concerns).

Quoting from the Federal Reserve Bulletin:

> "A list of notes receivable outstanding at the end of the fiscal period should be prepared, showing the dates the notes are made, the customers' names, the date due, the amounts of the notes and the interest, if any, contained in the notes. If discounted, the name of the discounting bank should be noted and verification obtained from the bank.
>
> "The outstanding notes must be carefully examined with the notes receivable book, and with the list prepared by or produced to the auditor, the due dates and the dates of making the notes being carefully checked, and when notes have been renewed the original dates

should be recorded. When notes have been paid since the close of the fiscal year, the cash should be traced into the books of the company, and, when they are in the hands of attorneys or bankers for collection, certificates should be obtained from the depositaries.

"When notes receivable are discounted by banks, the company has a liability therefor which should appear on the Balance Sheet. Lists of discounted notes not matured at the date of the audit should be obtained from the banks as verification and their totals entered under secured liabilities if the cash therefor is shown as an asset.

"The value of collateral, if any, held for notes should be ascertained, as it frequently happens that the notes are worth no more than the collateral.

"Notes due by officials and employees must always be stated separately from customers' notes, as must also notes received for other than trade transactions.

"Notes due from affiliated concerns must not be included as customers' notes, even though received as a result of trading transactions. Affiliated companies' notes should be shown as a separate item of current assets or as other assets as the circumstances warrant. They may be fairly included in current assets if the debtor company has ample margin of quick assets over its liabilities, including such notes."

3. AUDITING PROCEDURE

While one of the juniors counted the cash, the other junior prepared a list of the notes receivable owned by the Blank Manufacturing Company as at December 31, 1918. The Federal Reserve Bulletin stipulates that only a list should be made of the notes receivable outstanding at the end of the fiscal period, but it is believed to be better practice to make a complete list of all the notes receivable, whether on hand or outstanding for the reason that the information will be of value later on when calculating the accrued interest and in case any discrepancies are noted. Reference to the illustration on page 69 will show the junior's working sheet on which he prepared a list of the notes receivable.

Reference to page 51 will show that the management had estimated that 2% of the notes receivable will prove worthless. Investigation shows that this estimate is based on previous experience. However, a reserve of this kind would not be a permissible deduction on an income tax return, only actual losses within the year being allowed. Where experience and investigation show that beyond a doubt there will be a certain per cent of notes prove worthless, then it is sound accounting to set up a reserve. This will be discussed further in a later chapter.

Listing
Notes Receivable

THE BLANK MANUFACTURING CO.
Indianapolis, Ind.

J. I. King
Junior

No.	Date	Signature	Description	Int.	Due date	Amount		Discounted	Remarks
1	Nov. 1, 1918	J. B. Olds	Customer	6%	Feb. 1, 1919	$ 845	72		
2	Sept. 25, 1918	Robert Burns	Customer	6%	Jan. 25, 1919	3200			
*3	Dec. 10, 1918	The Oilox Co.	Customer	6%	Jan. 10, 1919	1000			Endorsed, James Oilander, Mgr.
*4	Aug. 22, 1918	J. A. Hewes & Co.	Customer	6%	Nov. 22, 1918	600			Protested-End. By J. A. Hewes.
*5	Dec. 24, 1918	L. W. Shields	Gen. Mgr.	5%	June 24, 1919	1500			
*6	Oct. 30, 1918	Alberts & Blackmar	Customer	6%	Jan. 30, 1919	4275		Dec. 1, 1918	Merchants' National Bank
*7	Nov. 18, 1918	R. O. Elmeier Co.	Customer	6%	Feb. 18, 1919	1485	28	Dec. 1, 1918	" " "
			TOTAL NOTES RECEIVABLE			12906	00		

*3 Paid Jan. 10, 1919--See cash book page 391.
*4 Note signed by J. A. Hewes & Co., per J. A. Hewes, Pres. Correspondence shows that they promised to make payment in full on Jan. 1, 1919.
*5 This note should be investigated. Chief Accountant says it was authorized by Board of Directors.
*6-7 These notes discounted. Verified at bank. Both endorsed by The Blank Manufacturing Co., per E. D. Carpenter, Pres.

(1A–Working Sheet, J. I. King, junior accountant.)

NOTE TO STUDENT—Each accountant prepares working papers showing detailed results of his work. Note that each uses a different system for numbering sheets. Instead of special ruled forms as above, ordinary analysis paper may be used if desired.

SECURITIES

Securities like notes receivable should be audited as soon as possible after the beginning of the audit and if possible, on the same day that the cash is counted.

1. ACCOUNTING THEORY

Investments are of two classes, speculative and non-speculative. When securities are purchased with the intention of holding them until such time as the market value may increase and enable the holder to sell at a profit, the investment is to be considered speculative. But when securities are purchased and held because of the income they produce, the investment is non-speculative.

Accounting for Speculative Investments. When securities are purchased either on a margin or by payment in full with the expectation of selling at any time when the market price is favorable, the investment is made, not because of the income the securities will produce, but because of the expectation of making a profit through a sale. In other words, these securities in a sense become the stock-in-trade of the investor and like any other stock-in-trade should be recorded at cost. An account may be opened with each class of security purchased or a summary account may be opened with Securities and a subsidiary record may be kept. The cost price of these securities includes broker's fees and any other expenses in connection with the purchase of the stock. To record these investments at their par value is wrong because it anticipates a profit or a loss at the time of the purchase, when in reality the profit or loss is realized only at the time of sale.

Accounting for Non-Speculative Investments. Non-speculative investments are of two kinds: Those intended as temporary producers of income and those intended to be held until maturity. The latter are to be considered as permanent investments.

Temporary Investments. Investments intented as temporary producers of income should undoubtedly be recorded at cost price and should be carried on the books at the market price at the time of the purchase. It is not possible to scientifically amortize the discount or premium on such securities because it is not known how long they will be held, and since it is not the intention of the investors to hold these securities until maturity, it will readily be seen that the only thing to do is to debit the account with Securities at actual cost price. When interest is collected it should be credited to an account with Interest on Investments. It is this account that indicates the amount of the income from the investment during the period.

In case the securities are sold at a profit or loss, there are two methods of procedure: the first is to credit the Securities account at the selling price regardless of what it may be. The difference between the cost price and the selling price of the securities would be the amount of profit or loss and is either an addition to or a deduction from income in the Profit and Loss statement. The second method is to credit the account with Securities with the cost price and to debit or credit a nominal account for the profit or loss resulting from the sale. The latter practice is to be commended because it distinguishes between real and nominal accounts. This is the same method of accounting as is advocated in connection with the sale of fixed assets.

Permanent Investments. There is a lack of uniformity in regard to the method of recording permanent investments. The accounting procedure becomes more complicated when securities are purchased with the intention of holding them until maturity. These securities may be recorded either at cost price or at their par value. If they are recorded at par, separate accounts should be carried for the discount or premium and another account for the interest. If the securities are recorded at cost, no separate accounts with Discount and Premium need be opened, but an account with Interest is kept to show the income.

Amortization of Bond Discount and Premium. If the bonds are recorded at par value, an account with Discount and Premium is charged or credited with the difference between the cost price and the par value. This account should then be amortized over the life of the bonds. There are two methods for making this distribution. These are known as the "straight line" and the "scientific" methods.

Straight Line Method. The straight line method consists in dividing the amount of premium by the interest periods the bonds have to run, the quotient being the amount to be amortized periodically. This method commends itself because of its simplicity and ease of operation but it is not scientifically correct.

Scientific Method. The scientific method is based upon compound interest calculations, the premium being looked upon as the amount of the present worth of the annuity, taking into consideration the rate of interest and the time in interest periods the bond has to run.

The scientific method is the better one as the interest is not overstated in the first periods as would be the case with the straight line method. However, the straight line method is allowed by the Department of Banking of the state of New York for valuing the investments of saving banks.

Accounting for Sinking Fund Investments. There are three classes of entries in connection with accounting for sinking funds.

1. (a) Those relating to the original payments to the sinking fund trustee; and (b) those relating to subsequent payments to the sinking fund trustee.

2. Those relating to the transactions consummated by the trustee. These entries are recorded at the time of the trustee's periodic report.

3. Those relating to the redemption of the debt and the final disposition of the accounts relating to the sinking fund.

The usual plan is to create a reserve out of profits equal to the amount of the sinking fund. The funds are placed in the hands of a trustee for investment. The income from the trustee's investments is usually considered an addition to the fund. The following are illustrative of the three classes of entries explained above:

First Class. At the time the original payments are made to the trustee, two entries are required.

1. Sinking Fund Trustees...........	xxxxx.xx	
Cash........................		xxxxx.xx
To record original payment to sinking fund trustee—sinking fund being created according to terms of trust agreement to retire the first mortgage bonds of the company.		
2. Surplus........................	xxxxx.xx	
Sinking Fund Reserve........		xxxxx.xx
To set up a reserve out of profits to provide funds for the redemption of bonds.		

All subsequent payments to the sinking fund trustee should be recorded in exactly the same manner as the original payments.

Second Class. Upon receipt of the trustee's report, it would be necessary to set up entries for all completed transactions of the trustee. These may include purchase of securities, collection of interest on securities, sale of securities, expenses incurred, etc. The trustee may purchase securities at a discount or premium, in which case the transaction involves the proper treatment of such discounts and premiums. This has already been discussed at some length and the same principles apply to sinking fund accounting as to general accounting. Assuming that bonds purchased by the trustee are to be recorded at par the following entry shows the proper procedure:

Sinking Fund Bonds.................	xxxxx.xx	
Sinking Fund Income (Accrued Int.)...	xxxxx.xx	
Sinking Fund Trustee............		xxxxx.xx
Sinking Fund Income (Discount)..		xxxxx.xx
To record the purchase of bonds with accrued interest at less than the par value.		

If the bonds have been purchased at a premium, the Sinking Fund Income account should be debited for the amount of such premium. The Sinking Fund Income account should be debited for accrued interest at the time of the purchase of bonds, for the premium when bonds are bought above par, and for expenses in connection with the sinking fund. The account should be credited for discount on bonds purchased below par and for interest collected on the bonds. Of course, separate accounts may be kept with Sinking Fund Income and Sinking Fund Expense, if desired. At the end of each year the Sinking Fund Income and Expense accounts should be closed into Profit and Loss. This profit and loss, of course, will later be closed into the Surplus account. The following entry is illustrative:

Sinking Fund Income................	xxxxx.xx	
Profit and Loss..................		xxxxx.xx
To close the net amount of the Income from the Sinking Fund into Profit and Loss.		

If the trustee purchases the company's own bonds, which is often done, there is practically no difference in recording the transaction. If the bonds are cancelled at the time of their purchase, the debit would be to the Bond account of the company instead of to Sinking Fund Bonds.

Third Class. When the bonds for which the sinking fund is created mature, the securities of the trustee must be converted into cash to be used for redeeming the bonds. Various entries may be required depending upon the transactions. The following are illustrative:

1. Sinking Fund Trustee............	xxxxx.xx	
Sinking Fund Bonds.........		xxxxx.xx
To record sale of bonds in the Sinking Fund.		
2. First Mortgage 6% Bonds........	xxxxx.xx	
Sinking Fund Trustee......		xxxxx.xx
To record redemption of bonds.		
3. Cash...........................	xxxxx.xx	
Sinking Fund Trustee......		xxxxx.xx
To record transfer of cash in hands of trustee to the company.		

If the bonds have been redeemed and cancelled, and the trustee has transferred the balance of cash back to the company the only thing left to be done is the closing of the Sinking Fund Reserve account into the Surplus account. This addition to surplus is available for dividends.

2. AUDITING THEORY

Quoting from the Federal Reserve Bulletin:

Listing the Securities

"Under this caption must be listed securities in which surplus funds of the company or firm have been temporarily invested and which are considered available as 'quick assets', i. e., can be turned into money in time of need. Where stocks or bonds represent control or a material interest in other enterprises, the ownership of which carries more or less value to the holder outside of the return thereon, they should be considered as fixed assets.

"A list of investments should be prepared showing—

- The dates of purchases.
- Descriptions of the investments.
- Par value of the investments.
- The denomination of the shares.
- The number of shares or bonds owned.
- The total capital stock of the various companies.
- The amounts paid for the investments.
- The interest and dividends received.
- The market values of the investments.
- The surplus or deficit shown by the Balance Sheets of the companies where no market quotations are available.
- If hypothecated, with whom and for what purpose.

"This list must be compared with the ledger accounts concerned, and the total of amounts paid according to the list must agree with the balance of the investment account or accounts.

"The securities must be examined by the auditor in person or he must secure confirmation of their existence from those who hold them as collateral. Those in possession of the company must be counted and examined as soon as possible after the audit starts, and all of them must be submitted to him at one time. It is much more satisfactory to see the actual securities

than to verify cash receipts and other evidences therefor after the audit has progressed some time.

"Certificates out for transfer must be verified by correspondence.

"Where the market values of securities are less than the book values, save where the variation is so small as to be trifling, a reserve for loss in value on the Balance Sheet date must be set up.

"Care must be taken to see that the certificates are made out in favor of the company, or that they are endorsed or accompanied by powers of attorney when they are in the names of individuals.

"Coupons on bonds must be examined to see that they are intact subsequent to the latest interest payment date.

"The investment schedule must show that the total interest and dividends receivable by the company have been duly accounted for; the income from the investments shown in the Profit and Loss account must be in accord with this schedule.

"When market quotations cannot be obtained for investments, the Balance Sheets of the companies in which investments are held must be examined so that the auditor may form an idea of their value.

"In verifying purchases of stock exchange securities the brokers' advices must in all cases be examined in connection with the verification of the purchase price.

"Investments in deeds and mortgages must be supported by both the mortgages and insurance policies, and, furthermore, it must be shown that all assessed taxes on the property have been duly paid, that the mortgages have been properly recorded, and that the insurance policies are correctly made out to the company.

"If any of the securities have been hypothecated the fact and amount (book value) must be stated under secured liabilities on the Balance Sheet."

An inexperienced junior must be very careful in auditing securities because of the fact that he is likely to be unfamiliar with the work and in his attempt to conceal his ignorance, will likely make errors that he would not otherwise make. Take all the time necessary to count the securities and prepare lists of them. Don't let anything or anybody interfere with your work, and don't stop until you know that you have a complete record of all securities held by the client, as well as a record of those outstanding, whether in the hands of the banks, stock brokers or out to be recorded. All these can be counted and checked with the list later.

3. AUDITING PROCEDURE

While the juniors were at work on the first day of the audit, the senior accountant counted and listed the securities. Reference to the Trial Balance will show that the only securities that are involved will be found in connection with the accounts, Sinking Fund and Investment of Surplus.

The surplus was found to be invested in 4¼% Liberty Bonds on May 9, 1918, being a part of the Third Liberty Loan, the interest on these bonds falls due on March 15 and September 15 each year. These were counted and there were found to be ten $1,000 Bonds with all coupons, not yet due, attached.

Verification of the sinking fund revealed that on January 2, 1918, there was set aside $15,000 in cash and deposited with the Merchants National Bank, who has been named as trustee for the fund. This is in agreement with the bondholders and it is understood that the President of the Merchants National Bank may invest this surplus in first real estate mortgages, paying not less than 6% interest, and the amount of the mortgage is in no event to exceed two thirds of the appraisal value of the real estate. After going over the matter with the President of the bank, it was found that the entire sum had been loaned to Harrison G. Matthews. A first mortgage was obtained dated January 10, 1918, with interest at 6% payable annually, and is based on city property valued at $25,000. This valuation being the basis for taxes. The loan is evidenced by a note secured by a first mortgage on the property.

THE LAW OF NEGOTIABLE INSTRUMENTS

Some contracts are "assignable" while others are "negotiable." We shall discuss here those conditions which make a contract negotiable. A negotiable contract is usually spoken of as a "negotiable instrument." There are three principal classes of negotiable instruments—notes, drafts and checks. It is essential that the accountant understand the essentials of negotiable instruments, hence the following discussion is based upon the essentials and non-essentials as stated in the Negotiable Instruments Law.*

Essentials of Negotiability. An instrument to be negotiable must conform to the following requirements:

1. Must be in writing and signed by the maker or drawer.

2. Must contain an unconditional promise or order to pay a sum certain in money.

*The Negotiable Instruments Law is a statute which was prepared by a commission on Uniform State Laws to modify and make uniform the Law of Negotiable Instruments throughout the United States. For the most part, it modifies the preexisting law. This law has been adopted without important amendments by all the states and the District of Columbia.

3. Must be payable on demand, or at a fixed or determinable future time.

4. Must be payable to order or to bearer; and

5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.

Additional Provisions Not Affecting Negotiability. An instrument which contains an order or promise to do any act in addition to the payment of money is not negotiable. But the negotiable character of an instrument otherwise negotiable is not affected by a provision which:

1. Authorizes the sale of collateral securities in case the instrument is not paid at maturity; or

2. Authorizes a confession of judgment if the instrument be not paid at maturity; or

3. Waives the benefit of any law intended for the advantage or protection of the obligor; or

4. Gives the holder an election to require something to be done in lieu of payment of money.

But nothing in this section shall validate any provision or stipulation otherwise illegal.

Non-essentials to Negotiability. The validity and negotiable character of an instrument are not affected by the fact that:

1. It is not dated; or

2. Does not specify the value given, or that any value has been given therefor; or

3. Does not specify the place where it is drawn or the place where it is payable.

When Date May Be Inserted. Where an instrument expressed to be payable at a fixed period after date is issued undated, or where the acceptance of an instrument payable at a fixed period after sight is undated any holder may insert therein the true date of issue or acceptance, and the instrument shall be payable accordingly. The insertion of a wrong date does not avoid the instrument in the hands of a subsequent holder in due course, but as to him, the date so inserted is to be regarded as the true date.

When Blanks May Be Filled In. Where the instrument is wanting in any material particular, the person in posses-

sion thereof has a prima facie authority to complete it by filling up the blanks therein. And a signature on a blank paper delivered by the person making the signature in order that the paper may be converted into a negotiable instrument operates as a prima facie authority to fill it up as such for any amount. In order, however, that any such instrument, when completed, may be enforced against any person who became a party thereto prior to its completion, it must be filled up strictly in accordance with the authority given and within a reasonable time. But if such instrument, after completion, is negotiated to a holder in due course, it is valid and effectual for all purposes in his hands, and he may enforce it as if it had been filled up strictly in accordance with the authority given and within a reasonable time.

When Provisions Conflict

1. Where there is a conflict between the written and printed provisions of the instrument, the written provisions prevail.

2. Where the sum payable is expressed in words and also in figures and there is a discrepancy between the two, the sum denoted by the words is the sum payable.

A. THEORY QUESTIONS

1. In examining securities, what data should be recorded to protect the auditor? What is to be apprehended? C. P. A. Ohio.

2. A concern has established a sinking fund for the retirement of a mortgage. An investment has been made in bonds the present market value of which is below cost. Would you inventory them at market value or at book value? Why? C. P. A. Mich.

3. Your verification of the securities of a corporation has to be made at a date about two months subsequent to the date of the Balance Sheet you are asked to certify. Can you suggest steps which will enable you to do this without risk of overlooking serious overstatement? Inst. Ex. 1918.

4. Describe two different methods for writing off the premiums on bonds and state which, in your opinion, is the best method. Inst. Ex. 1917.

5. In auditing a trust company's accounts, you find that the company is cotrustee for a number of estates. The securities are locked in a safe deposit box that cannot be opened without the assistance of the absent trustee, who will be away for several months. What precautions should be taken to safeguard the integrity of your audit? C. P. A. N. Y.

B. ACCOUNTING PROBLEMS

1. State in form of journal entries on books of John Brown the following transactions:

(a) Installment notes given by him on purchase of real estate; face of notes includes interest charges up to and including maturity of notes.
(b) Note of John Jones returned from the bank with a protest charge after having been left for collection.

C. P. A. Ark. and Me.

2. The Oak Furniture Company placed $50,000 of its undivided earnings in the hands of a broker to invest in United States 4% bonds. The bonds were $1,000 each and cost 101 3/8, commission 1/8. Prepare journal entries to record properly the transaction on the company's books. C. P. A. N. Y.

3. Give examples of the proper entries when the following transactions occur in respect to Notes Receivable:

1. When a note is received.
2. When a note is discounted.
3. When a note is paid.
4. When a note is partly paid and a new note given for the balance.
5. When a note is collected by the bank.
6. When a note is protested. C. P. A. Mich.

4. A company is under obligations to pay $10,000 to sinking fund trustees "out of profits". The following transactions take place:

1914–Dec.	31.	$10,000 cash paid to sinking fund trustees.
1915–Jan.	5.	Trustees invest $10,000 of the 5% bonds of the company at ninety-eight and interest (from January 1.)
July	1.	Coupons on above bonds collected.
Dec.	31.	$10,000 paid to sinking fund trustees.
1916–Jan.	1.	Coupons collected.
	2.	$11,000 bonds bought for sinking fund at ninety-five.
July	1.	Coupons collected.
Dec.	31.	$125 paid for expenses of sinking fund.
	31.	$10,000 paid to sinking fund trustees.
1917–Jan.	1.	Coupons collected.
	10.	$10,000 bonds bought at one hundred and one and interest.

Give the journal entries on the company's books for the above transactions. Inst. Ex. 1917.

C. LEGAL QUESTIONS

1. State all the essential legal requirements of a contract constituting a valid negotiable note. Inst. Ex. 1917.

2. A executes and delivers to B an undated negotiable note, payable 60 days after date. B inserts a wrong date (not the date of delivery) and the note passes in due course to C. What is the effect of the insertion as to the maturity of note as to C? Does it avoid the instrument in his hands?

Inst. Ex. 1918.

3. Under the Negotiable Instrument Law:

(a) If there is a conflict between the written and printed provisions in a note, which one controls?

(b) Where there is a discrepancy between the words and figures in a note, which one controls?

C. P. A. Mich.

4. New York, October 1, 1917

One month after date I promise to pay John Smith Five Hundred Dollars for value received, negotiable and payable without defalcation or discount.

(Signed) Henry Jones.

Is the above note negotiable or not? Give reasons.

Inst. Ex. 1917

5. Are the following notes negotiable or not? Give reasons.

(a) No date, nor place.

I promise to pay bearer One Hundred Dollars.

(Signed) A. B.

(b) January 5, 1917.

Due A. B. or order on demand One Hundred Dollars.

(Signed) C. D.

(c) Chicago, Sept. 5, 1916.

On or before Dec. 1, 1916, I promise to pay to C. D. or order One Hundred Dollars.

(Signed) A. B.

(d) New York, April 10, 1916.

On............I promise to pay to the order of C. D. One Hundred Dollars.

(Signed) A. B.

Inst. Ex. 1917.

Chapter Six

ACCOUNTS RECEIVABLE

Reference to the Trial Balance on page 50 of Chapter Four will show that the amount of accounts receivable on December 31, 1918, taken from the books of the Blank Manufacturing Company, is $81,687.00.

1. ACCOUNTING THEORY

The Sales Ledger. While accounts with customers may be kept in the general ledger, it is usually better practice to keep a subsidiary ledger containing only the accounts with trade customers. Different titles as applied to such a ledger were discussed in Chapter Three, page 36. It is important that only trade customers' accounts be kept in this ledger. Any accounts with officers, stockholders or employees should be kept in the general ledger and should be listed on the Balance Sheet as a separate item. Under no circumstances, should such accounts be included with accounts receivable.

The Sales Ledger Controlling Account. If a subsidiary ledger is kept with customers, it will be necessary to keep a controlling account in the general ledger. The purpose of such an account is to show the total amount due from customers without the necessity of preparing a schedule of all accounts in the sales ledger.

To establish a subsidiary sales ledger and a controlling account in the general ledger, assuming that customers' accounts have previously been kept in the general ledger, make a journal entry as follows:

Sales Ledger....................	xxxxx.xx	
Accounts with customers.....		xxxxx.xx
To establish a subsidiary ledger for accounts with trade customers. See schedule of customers' accounts following: (There should follow a schedule of all customers' accounts showing balances due.)		

The Sales Ledger account should be debited with the total amount due on account from customers and each account in the sales ledger should be debited for the balance due. At the same time, each customer's account in the general ledger should be credited with the balance due. Note that the debit entry is really posted twice: First, in one sum to the debit of the controlling account in the general ledger; second, to the debit of each customer's account in the sales ledger, in amount as shown on the schedule of accounts receivable. Since, however, the sales ledger is considered a subsidiary ledger and will not necessarily be taken into consideration when preparing a Trial Balance, the double posting of the debit item will not affect the equilibrium of the general ledger. After the entry has been properly posted all customers' accounts in the general ledger will be in balance, but each account in the sales ledger will show balance due on account. The Sales Ledger account in the general ledger will show the total amount due from customers.

Accounts with customers in the sales ledger are debited and credited with the individual transactions in the same manner as though they were a part of the general ledger. In other words, all transactions recorded in any of the books of original entry which affect a customer's account will be posted to the customer's account in the sales ledger. The Sales Ledger controlling account will also be debited for all sums posted to the debit of the individual accounts in the sales ledger and will be credited for all sums posted to the credit of the customers' accounts in the sales ledger. However, the controlling account is a summary account and usually the posting to this account is done at the end of each month, only the totals being posted from each book of original entry. For instance, special columns may be provided in the journal, cash book, sales returns book and notes receivable book, and the totals of these columns may be posted at the end of the month. Where no special columns are provided, then the individual items will be posted. After all posting has been done the Sales Ledger account will show the total amount due from customers. This can be verified by preparing a schedule of the balances of the accounts with customers from the sales ledger.

Discounts. In the treatment of the accounts with customers, the subject of trade and cash discounts will come up. There has been considerable discussion by accountants with regard to the proper treatment of discounts. It is not considered good policy to permit trade discounts to appear in the ledger at all. In billing customers, trade discounts should be deducted from the invoices before they are mailed out. Likewise, before invoices are entered in the purchases record, all trade discounts should be deducted.

A trade discount is usually a deduction from the list price regardless of the time of payment. Even though the terms of the invoice indicated that the discount would not be allowed

after thirty days, if the rate were greater than 2%, it would seem to be a trade discount, for it is apparent that anyone would most certainly take advantage of any such discount even if it were necessary to borrow the money at the bank paying 6% interest. It certainly would be better policy to pay 6% annual interest on borrowed money than to lose 2% discount per month on purchases.

Mr. Montgomery, says:

> "The distinction, therefore, is based on the answer to the query: Is the rate one which is obviously granted for anticipation of obligations not due? For instance, the strict enforcement of the terms '2 per cent ten days, net thirty days' indicates that the 2 per cent is an earning and not a deduction from the purchase price. As a general rule any discount in excess of the terms just mentioned may be treated as a trade discount."

Many accountants consider a discount greater than one per cent as a trade discount and it will be noted under the discussion of "Auditing Theory" on page 84 of this chapter, that the Federal Reserve Board advocates that any discount exceeding one per cent is to be treated as a trade discount, and if it has not been deducted from the invoices before recording them in the purchases book, there should be a reserve therefor set up in the Balance Sheet.

Doubtful Accounts. As soon as an account is known to be worthless it should be written off entirely; however, it frequently happens that an account will be past due at the end of a fiscal period, yet it is still considered good and it may not be wise to write it off as a loss. Some firms keep a doubtful accounts ledger, and when an account is past due and considered at all doubtful, it is written off the regular sales ledger and transferred to the doubtful accounts ledger. At the same time, a reserve is set up charging the current period with the estimated loss on such accounts. Other firms simply leave all accounts stand open in the sales ledger until they are either collected or are found to be absolutely worthless, and set up a reserve at the end of the fiscal period for an amount estimated to be sufficient to cover the loss. The Treasury Department will only allow as a deduction from income the actual amount of bad debts written off, but this doesn't mean that all doubtful accounts should be written off before determing to a certainty that they are uncollectible. Returns are always subject to inspection by Income Tax collectors or inspectors, and if accounts considered good by the inspector have been charged off they most certainly would not be allowed. Furthermore, any accounts written off and subsequently collected would be taxable as income in a later period. Of course, it frequently happens that an account considered worthless is later collected in full or in part. This should be considered as a special income.

2. AUDITING THEORY

Quoting from the Federal Reserve Bulletin:

Aging Accounts. "The bookkeepers of the accounts receivable ledgers should be asked to draw off lists of the open balances at the end of the fiscal period, and distributions of the total columns should be shown on the lists according to the age of the accounts, e. g., not yet due, less than 30 days past due, more than 30 days past due. (This is known as aging accounts receivable). The accounts paid since the close of the fiscal period should be noted in the lists before taking up the matter of past-due accounts with the credit department, as payment is the best proof that an account was good at the date of the audit.

Schedules Agree With Controlling Accounts. "The totals of the lists of outstanding accounts should agree with the controlling account in the general ledger if separate ledgers are kept. When credit balances appear on customers' accounts they should be shown on the Balance Sheet as a separate item and not deducted from the total of debit balances; and debit balances on the accounts payable ledgers should be treated in the same manner.

Lists Verified. "The lists must be footed and compared in detail with the customers' accounts in the ledgers.

Accounts Past Due. "The composition of outstanding balances should be examined, as it frequently happens that while a customer may be making regular payments on his account, old items are being carried forward which have been in dispute for a considerable period of time. Such items and accounts which are past due should be taken up with the credit department or some responsible officer, and the correspondence with the customers examined, so that the auditor may form an opinion of the worth of the accounts and satisfy himself that the reserve for doubtful accounts set up by the company is sufficient.

Discounts. "Trade discounts (and also so-called cash discounts, if exceeding 1 per cent) and freights allowed by the company should be inquired into, and if they have been included in the accounts receivable, a reserve therefor should be set up in the Balance Sheet. Also inquiries should be made regarding customers' claims for reductions in prices and for rebates and allowances on account of defective materials, so that it may be seen that a sufficient reserve has been established therefor.

Accounts Assigned, Bad Debts, Deposits, etc. "Inquiry must be made as to whether any of the accounts receivable have been hypothecated or assigned, and the sum total of accounts so listed entered under 20b. (See page 41, Chapter Three.)

"The auditor should satisfy himself that the bad debts written off have been duly authorized by responsible officials.

"Accounts due from directors, officers, and employees must be stated in the Balance Sheet separately and not included as trade accounts. This applies also to deposits as security, guaranties, and other extraordinary items not connected with sales.

"Accounts due from affiliated concerns must not be included as customers' accounts, even though arising as a result of trading transactions. Affiliated companies' accounts should be shown as a separate item of 'current assets' or as 'other assets', as the circumstances warrant. They may be fairly included as 'current assets' if the debtor company has ample margin of quick assets over its liabilities, including such accounts.

Verification of Accounts. "Optional.—The best verification of an open balance is a confirmation by the customer; therefore, if time permits and the client does not object, it is advisable to circularize the customers. The auditor should personally see the circulars mailed after comparing them with the lists of outstanding accounts. The envelopes for replies sent with the circulars should be addressed direct to the auditor.

"In large concerns the system of accounting is generally so arranged that it would be almost impossible for accounts to be paid and not correctly credited on the accounts receivable ledgers, but in small concerns, with imperfect systems, such occurrences are quite possible, so much so, in fact, that it is generally admitted that the risk of errors and omissions decreases in direct proportion to an increase in bookkeeping."

3. AUDITING PROCEDURE

Space will not permit a detailed record of the auditor's work in connection with the verification of accounts receivable, therefore, we shall limit our discussion to an outline showing the procedure of the audit.

(1.) A transcript of the Sales Ledger controlling account in the general ledger was made showing a balance of $81,687.00.

(2.) The schedule of accounts receivable furnished the senior by Mr. Pond, the chief accountant, was checked with the sales ledger and it was found that the total of all the accounts with debit balances amounted to $84,721.50, while the total of those accounts which had credit balances amounted to $3,034.50.

(3.) Terms on which goods are sold, net 30 days, no cash discount allowed. Trade discounts are all deducted from the invoices and no accounts with these discounts is maintained in the ledger.

(4.) The junior next divided the accounts receivable into three lists: Those not yet due; those less than 30 days past due; and those more than 30 days past due. The results showed accounts amounting to $73,807.80 were not yet due, accounts amounting to $8,755.70 were less than 30 days past due, and accounts amounting to $2,158.00 were more than 30 days past due. After this was completed those accounts more than 30 days past due were taken up with the credit man and carefully analyzed.

(5.) It was ascertained that at the beginning of the year, January 1, 1918, the total of accounts receivable amounted to $51,200.00. A reserve for bad debts amounting to 2% was set up at that time. During the year accounts amounting to $970.00

were found to be worthless and were charged off by debiting the reserve account. These were found to have been duly authorized. Conversation with the credit man revealed the fact that the experience of the Company during the past five years indicated that their annual losses from bad debts amounted to approximately 2% of the total accounts receivable.

(6.) No accounts were found to be hypothecated or assigned.

(7.) No accounts from directors, officers or employees were found to be included in the accounts receivable; also that there were no deposits, guarantees, or any extraordinary items included. The credit balances noted in connection with a few of the customers' accounts were found to represent overpayments, allowances on merchandise returned and other allowances on account of just claims.

(8.) With the consent of the client, statements were made out and mailed to all customers. By means of a rubber stamp the following notice appeared on each statement:

> Please examine this account immediately. If incorrect, address J. F. Sherwood, Certified Public Accountant and Auditor, 309 West Third St., Cincinnati, Ohio.

4. INCOME TAX PROCEDURE

Reserve for Bad Debts not a Deduction from Income. In preparing Income Tax returns the amount set up as a reserve for bad debts is not a deduction from income, only the specific debts actually charged off during the year may be deducted.

> **Income Tax Law.** Section 214. (a) [Individuals]. "That in computing net income there shall be allowed as deductions:
>
> (7.) "Debts ascertained to be worthless and charged off within the taxable year."
>
> Section 234. (a) [Corporations] "That in computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as deductions:
>
> (5). "Debts ascertained to be worthless and charged off within the taxable year."

(*T. D. 2433, January 8, 1917) "Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., are deductible only when definitely determined as the result of a closed or completed transaction and are charged off."

*Tax Decision.

There has been great dissatisfaction over this phase of the Income Tax Law for in most cases the only difference between the net profit shown on the books of account and the Income Tax returns has been the item of bad debts. Some bookkeepers and business men have conceived the idea that it is not permissible to set up a reserve for bad debts under the Income Tax Law. This is incorrect; in fact, the failure to set up reserves is opposed to correct accounting and if reflected in a Balance Sheet in some states will subject the person who signs it to severe penalties, including imprisonment for obtaining credit upon a false financial statement. However, under the Treasury regulations, the Income Tax returns must ignore the results shown in the books of account. One can claim as deductions only debts charged off within the year and must not use the amount set up as a reserve for debts not yet charged off. In order to comply with existing regulations, taxpayers should be careful to include in their returns all accounts charged off as bad during the year, whether debited in the books to reserve accounts, to Bad Debts account, or to the Profit and Loss account.

Definition of a Bad Debt. (Regulation No. 33, 1918, ¶95.) "A bad debt or worthless debt, as contemplated by the Income Tax Law and which may be deducted in a return of income, is a debt which has been actually ascertained to be worthless and charged off within the taxable year."

(Reg. No. 1918, ¶94.) "Where all of the surrounding and attendant circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient showing of the worthlessness of the debt for purposes of deduction."

Bad Debts Charged off and Later Collected Must Be Considered Income. (Reg. No. 33, 1918, ¶14.) [Individuals] "Bad debts which have been claimed and allowed as a deduction in prior returns are considered income if subsequently collected."

(Reg. No. 33, 1918, ¶380.) [Corporations] "Bad debts or accounts charged off by a corporation because of the fact that they were determined to be worthless, and subsequently recovered, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. Neither the date at which the debt was charged off nor the fact that it was or was not deducted from gross income in any return made for tax purposes will in any way affect its character as income of the year in which recovered."

Income Corresponding To Bad Debt Must Have Been Represented in Tax Returns In Order To Be Deductible. (Reg. No. 33, 1918, ¶96.) "Debts arising from unpaid wages, salaries, rents and items of similar taxable income will not be allowed as a deduction unless the income they represent has been

included in the return of gross income for the year in which the deduction as a bad debt is sought to be made or in a previous year and the debts themselves have been actually ascertained to be worthless and charged off."

The following questions and answers taken from the Income Tax Primer, 1918, will furnish additional information:

(Question 94.) "If, on account of friendship or relationship I advanced a certain sum to assist a needy friend or relative, and at the time such advance was made I had little or no reason to expect that the amount so advanced would ever be returned, may I now claim a deduction to cover such advance?

"No. Such an advance, partaking, as it does, somewhat of the nature of a philanthropic donation or a good will offering, is not held to constitute a bona fide debt."

(Question 96.) "A professional man earned a fee in 1916. As he keeps no books, he reports his income for tax purposes on an actual receipt basis. As this fee has never been reported as income, can it be claimed as a deduction if collection can not be made?

"No; never having been returned as income it cannot be claimed as a deduction."

(Question 91.) "In 1917 a corporation or a firm to which I had loaned money became bankrupt. Can this debt be considered absolutely worthless and claimed as a deduction for 1917?

"No, unless the affairs of the debtor have been finally adjusted, its assets sold for the benefit of, or distributed to, its creditors, and its receiver in bankruptcy discharged. If all this has occurred during the year 1917, so much of the debt as remains unpaid after the receiver is discharged may be claimed as a deduction for the year 1917."

(Question 92). "Is it absolutely necessary that the debtor corporation or firm mentioned in the ninety-first inquiry be declared a bankrupt and its receiver discharged before I can claim a deduction on account of the debt in question?

"No. If the debtor corporation has no assets whatsoever, and it is definitely known that nothing whatsoever can be collected from debtor itself or any person connected with it, a creditor need not go to the expense of instituting bankruptcy proceedings in order to establish his right to claim the worthless debt as a deduction."

5. LEGAL PHASES

An Account Stated. This is defined in Webster's Dictionary as "an account presented and accepted by both parties."

Therefore, it would seem to mean an account rendered and agreed to by both the buyer and seller, consequently in a suit

for collection, it would not be neccessary to prove the items composing the account, because each of the parties concerned had previously agreed to them as stated in the account.

Proceedings for the Collection of an Unsecured Debt. When a debt is unsecured, it is first necessary to bring suit and to secure a judgment against the debtor before the court will grant an execution. An execution takes the form of an attachment and a sale by the sheriff of the debtor's property after being advertised in the manner required by law. There are certain exemptions that apply and these are definitely enumerated by the statutes covering the matter in the various states. An execution can only be enforced against property within the jurisdiction of the court granting it, and if there is property belonging to the debtor not in the jurisdiction, it would be necessary to file a transcript of the judgment and secure another execution. It may be necessary to obtain a new judgment for property outside of the state.

An Account "Outlawed." The Statue of Limitations applies to open accounts as well as to notes and judgments. An open account is said to be "outlawed" if not collected within the time limit set by law. This varies in the different states from two to eight years. However, if a part payment is made on an account, then the time limit is automatically extended from that date. The limit on a judgment is much longer than on an open account and varies from five to twenty years. An auditor in verifying accounts receivable should always be on the lookout for accounts long past due. These accounts if more than two years old might be uncollectible. The same is true with regard to a judgment. It would be well for the student to obtain a copy of the Statute of Limitations of his state.

Applying Part Payments on an Account. A debtor has the right by law to indicate on what item his payment shall be applied. Hence, if he owes several amounts and wishes the payment to be applied on any one particular amount and requests it, the credit must be applied on that amount.

A partial payment made on a debt bearing interest is first applied in payment of interest, and if more than sufficient, the remainder is applied in payment of the principal.

Payment at Maturity. Payment of a debt must be made on the day it falls due, unless it be a holiday, in which case it must be made the next secular or business day. If a debt is not paid when it becomes due, it must bear interest from that date until paid. Payment must be made to the creditor personally, or his duly authorized agent, at the creditor's office, residence or wherever he may be, the debtor being required to find his creditor and not the creditor to seek his debtor.

Receipt—A Matter of Courtesy. A debtor cannot insist upon a receipt as a condition precedent to payment of a debt when it is his duty to pay. A debtor is not legally entitled to a receipt except as follows:

1. In some instances the statute makes it the duty of a public officer to give a receipt for money paid to him in his official capacity.

2. In a number of the states it is provided by statute that a person making a tender may demand a receipt in writing, duly signed, as a condition precedent to delivery.

The Sales Contract. There is a difference between "sales" and "contracts to sell." The following definitions are taken from the Uniform Sales Act:*

"A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price."

"A contract to sell goods is a contract whereby the seller agrees to transfer the property in goods to the buyer for a consideration called the price."

An actual sale is sometimes called an "executed contract sale," whereas a contract to sell is called an "executory contract of sale."

Essentials of a Valid Sale. All the usual essentials of an ordinary contract apply to sales.

1. Competent parties. Both the seller and buyer, legally known as the vendor and vendee, must be competent to contract.

2. Mutual assent. There must be an agreement between the parties that the title to the thing sold is to be transferred to the buyer.

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*The Uniform Sales Act was prepared by a commission on Uniform State Laws. The commission was appointed by the various states to unite in working out uniform laws governing sales. As a result of the work of this committee, we have three different acts relating to sales and allied subjects:

(a) The Uniform Sales Act.
(b) The Uniform Warehouse Receipts Act.
(c) The Uniform Bills of Lading Act.

The Uniform Sales Act has now been adopted in the following states:

Arizona	Minnesota	Oregon
Connecticut	Mississippi	Pennsylvania
Idaho	Missouri	Rhode Island
Illinois	Nevada	Tennessee
Iowa	New Jersey	Utah
Maryland	New York	Wisconsin
Massachusetts	North Dakota	Wyoming
Michigan	Ohio	Alaska (Terr.)

3. Legal Subject Matter. The seller must possess ownership of the title of the goods in order to be able to convey title to the buyer. One who sells property to which he has no title such as lost, stolen or borrowed goods, passes no right of possession to an innocent buyer. The seller cannot transfer the ownership of something which is not in existence, or of something which he does not own. He can, however, enter into an executory contract of sale whereby he may agree to sell goods to be manufactured, altered, delivered, etc., before actually passing the title to the buyer.

4. Consideration. There can be no sale without a price. It is this element that distinguishes a sale from a gift or a barter. When property is transferred by gift, title is passed as soon as it is delivered to the recipient and cannot be recovered by the giver. A barter is a trade whereby goods are exchanged for other goods instead of for money.

A contract of sale is valid, however, even though no price is mentioned, because the court will assume that the goods are to be paid for at a reasonable price and the buyer will be charged accordingly. If goods are ordered and it is agreed that the price is to be fixed at a later date, there is neither a sale nor a contract to sell because one of the essentials of the contract has been omitted. However, there may be provisions in the contract to the effect that the price is made dependent on outside circumstances. For instance, the price may be the market price on the day of delivery, or it may be agreed that the price is to be fixed by a third party. The fact that the price may be inadequate or excessive does not invalidate a sale or a contract to sell. If the parties to a contract are competent and yet one of them enters into a poor bargain, the court will not extend relief or sympathy.

5. Contracts to sell must comply with the Statute of Frauds. The Statute of Frauds applies to contracts to sell where delivery is to be made later and where the value is over a certain amount. This amount varies in the different states, ranging from $30.00 in Arkansas, Maine and Missouri to $500.00 in Arizona, Massachusetts, New Jersey and Rhode Island, and up to $2,500.00 in Ohio, but $50.00 is the usual sum.

Where the Uniform Sales Act has been passed, the value of the goods is the basis, but in many states the statutes specify that the price is the basis. Where the amount is based on the price then it may be fixed by the parties themselves, but when it is based on the value then the actual market value is used. Therefore, any contract to sell goods, amounting in value to more than the specified sum in that state, to be enforceable, must be supported by a written memorandum of the terms of the agreement signed by the party against whom it is sought to force the contract or his agent. This memorandum need not

be formal; it may be merely a note, a letter, a telegram, a receipt or miscellaneous papers connected in some way so as to make an intelligent contract.

There are two exceptions to the above: First, in case the buyer has paid part of the purchase price; second, in case the buyer has accepted and actually received part of the goods. Hence, a part payment will bind a bargain to sell goods, but it is a poor substitute for a written contract. Likewise, if a purchaser has accepted all or part of the goods the contract will be binding, but at the same time, the purchaser might still dispute the prices, warranties and other terms of the agreement. WRITTEN CONTRACTS ARE THE ONLY DEPENDABLE MEANS FOR PROVING AGREEMENTS.

Warranties. A warranty is defined in Webster's dictionary as "an assurance or undertaking by the seller of property, expressed or implied, that the property is or shall be as it is represented, or promised to be as to quantity, quality or title."

An expressed warranty is a statement made by the seller concerning the quality, durability, working ability, etc., of the article sold in order to induce the buyer to purchase. In the case of a sale the warranty may be either oral or written, but in the case of a contract to sell goods over a certain sum in value, then it should be in writing. These statements must be definite and not qualified. It is often difficult to determine the difference between statements of fact and expressions of opinion. The buyer must be on the lookout to detect mere expressions of opinion. "Get-rich-quick" schemes are unloaded on an unsuspecting public because they do not note the difference between a statement of fact and misrepresentation or an expression of opinion.

In every sale there are certain implied warranties. The seller warrants by the mere act of selling goods (a) that he has the right to sell, or in the case of a contract sale that he will have the right to sell when the time for the sale arrives; (b) that the buyer shall not be disturbed by claims made by others against the goods he has purchased; (c) that the goods are free from claims, charges or incumbrances at the time of sale.

Remedies. The seller has certain defined remedies for wrongful acts of the buyer. The buyer also has certain remedies in case of breach of contract or breach of warranty by the seller.

Under certain conditions the seller may recover the sale price and under other conditions he may recover damages. If the seller contracts to sell and tenders the goods covered by the contract and the buyer refuses to receive the goods without just cause, he may recover the sale price, or he may elect to retain the goods and recover damages. Usually the amount of damages

will be the difference between the market price of the goods and the contract price.

There are so many exceptions to the general rules concerning contracts to sell and sales that all can not be enumerated here. In actual practice, specific cases involving a knowledge of the statutes will often occur, but the accountant or auditor will always be able to look up the statutes in question before making decisions.

Auction Sales. Auction sales are made in accordance with the terms printed on the hand bills advertising it. Deposits may be required before one is entitled to bid, or deposits may be required after the bid is made. All bids below a certain sum may be refused, but it is customary to sell to the highest bidder. Before bidding on goods offered at auction sale, one should acquaint himself with the terms of sale.

A. THEORY QUESTIONS

1. Explain in full your method of arriving at a correct allowance for bad debts. C. P. A. Mich.

2. Differentiate between the following discounts, viz: 2% 10 days, 30 days net; and 5% on settlement. C. P. A. Ind.

3. A corporation has a controlling account in the general ledger for accounts receivable. The balance of the controlling account is $80,000. The debit balances of the individual accounts total $100,000, and the credit balances total $20,000. Is a statement correct which uses the controlling account balance as an asset? If not, what would you do? Give reasons. C. P. A. Mich.

4. Mention three classes of transactions which a debit item may represent in a customer's account.
Inst. Ex. 1918.

5. Indicate what would guide you in examining and criticising accounts receivable carried on the branch office books of a business. What would you require before
(a) accepting the debits as good or
(b) writing off those you were told were bad?
Inst. Ex. 1918.

B. ACCOUNTING PROBLEMS

1. When auditing the books of a company which are not in balance, the following errors are discovered:

(1) A check drawn for $110 is entered in the cash book as a collection of $100 and posted to the debit of the creditor's account as $110.

(2) A customer's credit memo of $25 is included as a sale and posted to the credit of the customer's account as $20.

(3) The debit side of the cash book is underfooted $100, and a check drawn for $100 in payment of a creditor's account is not entered in the cash book.

(4) Discounts received of $250 are posted as discounts allowed.

To correct the foregoing errors, prepare journal entries for accounts in the general ledger and subsidiary ledgers which are controlled by accounts in the general ledger.

C. P. A. Kans. and Mo.

(Note. When errors are found in an audit of the accounts, adjusting entries are necessary. These are usually made in the general journal and posted to the accounts affected. The first item is not quite clear, but you may assume that through the use of controlling columns the following entry was made in the cash book:

Cash	$100.00	
Customer's controlling account		$100.00

The above entry was posted as a debit of $110 to the correct individual creditor's account.

The other items should be easily understood and there should be no difficulty experienced in framing an adjusting entry for each.)

2. The Trial Balance of a manufacturing firm taken January 1, 1897, is as follows:

Capital A		$40,000
Capital B		20,000
Plant and Machinery	$35,000	
Purchases	38,000	
Sales		95,000
Stock on hand January 1, 1896	15,000	
Labor	24,000	
Salaries	6,000	
Traveling Expenses	2,500	
Interest	600	
Stationery and Printing	1,200	
Rents and Taxes	3,500	
Discounts and Allowances	1,250	
Fuel	3,000	
Insurance (one year from July 1, 1896)	1,150	
Freight	1,500	
General Expenses	600	
Bank Overdraft		5,000
Creditors		4,000
Accounts Receivable	25,000	
Rent of Steam Power		1,500
Cash on hand	200	
Loan Account	7,000	
	$165,500	$165,500

Stock on hand January 1, 1897, $23,000; each partner to be credited 6% on his capital for one year before profits are ascertained; 3% to be written off accounts with creditors for discount; 10% to be written off machinery and plant for depreciation; unexpired insurance to be taken into account; net profit to be divided 2–3 to A and 1–3 to B. Draft adjusting and closing entries. Prepare final Trial Balance and a Balance Sheet. You need not set up ledger accounts as a part of your solution. C. P. A. N. Y.

(Note. Do not misinterpret the item "3% to be written off accounts with creditors for discount." It appears that there is a trade discount of 3% that was not deducted from the invoices before they were entered on the books; therefore, an adjusting entry is necessary. The following entry is the proper adjustment:

Trade Discounts	$120.00	
Purchases		$120.00

To write off a trade discount of 3% on purchases, same not having been deducted from the invoices before they were entered on the books.

The amount of the reserve for trade discounts should be deducted from the sum of accounts payable in the Balance Sheet.)

3. The following figures are taken from the books of A. B. Mills as at December 31, 1906. You are requested to prepare from them a Trial Balance and a Balance Sheet. The period is one year.

Yarn (used)	$25,000
Sales	81,250
Wages	22,500
Discounts Received	2,500
Dyeing	12,500
Power, Light and Heat	3,125
Boxes and Cases	1,250
Repairs	685
Sundry Expenses (Mills)	1,060
Insurance	155
Salaries	2,500
Taxes	310
Depreciation	425
Advertising	1,250
Traveling Expenses	1,125
Returns	1,000
Commissions	1,875
Discounts Allowed	440
Interest on Loans	410
Cash at Bank and on hand	14,065
Bills Payable	37,500
Sundry Debtors	22,500
Sundry Creditors	6,250

(*Concluded on page 96*)

Fixtures, Fittings, Office	4,750
Capital	93,750
Machinery and Plant	65,925
Bills Receivable	38,400

(**Note.** The above problem is taken from the final examination of the Society of Accountants and Auditors in London, England, June, 1907.)

C. LEGAL QUESTIONS

1. (a) What does a seller impliedly warrant in the sale of a chattel?

(b) State all the legal requisites of a valid sale.
Inst. Ex.

2. Define a sale. What is the difference between a sale and an exchange or barter? C. P. A. Ind.

3. Can a merchant sell articles that he is to manufacture next season? C. P. A. Ind.

4. What is an account stated? C. P. A. Mich.

5. Answer briefly:

(a) What is a debt and what can a creditor demand in payment of a debt?

(b) When a creditor accepts in satisfaction payment of less than the full amount of a debt, how can the debtor guard against further demands?

(c) When, where and to whom must payment of a debt be made?

(d) Is the debtor legally entitled to a receipt?

(e) Which has the prior right to apply a payment against any one of several debts, the debtor or the creditor?

(f) When a partial payment is made on a debt bearing interest, in what manner is it applied? C. P. A. N. Y.

Chapter Seven

INVENTORIES

Reference to the inventory of the Blank Manufacturing Company, on page 51 of Chapter Four, will show that the inventory is made up as follows: Finished stock, $80,000.00; materials and stock in process, $55,000.00.

1. ACCOUNTING THEORY

Book Inventories. There is a growing tendency on the part of manufacturing and trading concerns to keep a merchandise stock ledger, commonly known as a "running" or "going" inventory. Every business firm keeps a record of cash regardless of what other records are kept. It is difficult to understand why it isn't just as important to keep an accurate record of merchandise as it is of cash. Without a doubt, the loss from thefts and misappropriation of merchandise amounts to more in a year than embezzlements of cash amount to in a decade. It is a well known fact that merchandise, worth millions of dollars, is carried away annually by employees and others because they know it will never be discovered. In the face of these facts, it would seem to be equally important to keep an accurate record of all merchandise, whether the business is a trading or a manufacturing concern.

Without the waste of time, labor and delay incident to stocktaking, the manufacturer and trader should, at all times, know exactly how he stands concerning the amount and value at cost price of all stock on hand, whether it be raw material, goods in process of manufacture, or finished goods.

If a separate merchandise stock ledger is kept, then it will be necessary to maintain a controlling account in the general ledger the same as for any other subsidiary ledger. The accounts in the merchandise stock ledger will usually show on the debit side quantities purchased, cost per unit and amount; on the credit side quantities sold, cost per unit and cost of quantity sold. A balance column is also provided so that there is shown quantities on hand, cost per unit and total amount or value at cost price. Where prices are subject to fluctuations or have fluctuated considerably, the average cost and amount is often used. It is better, however, to use the exact cost per unit and exact amount where it can be ascertained, and it usually can be ascertained.

Physical Inventories. Whether or not a book inventory is maintained, it is important that at least once a year, and oftener in some cases, a physical inventory be taken. For the same reason that cash is counted to verify the cash book balance so an inventory should be taken to verify the result shown by the stock records. In the event that there is a differentiation between the physical and book inventories, it should be of as great concern as a shortage of cash. Isn't it a fact that merchandise represents money's worth? If a cashier is short in his cash, he must pay it out of his pocket or the proprietor must pay it out of his capital. Why should not the liability of either the store-keeper or stock-keeper be regarded in the same light as is the cashier with respect to responsibility?

At the present time most accounting firms agree that the inventory should be taken at cost price or market price, whichever may be the lower, but in no event should it be taken at a price higher than the actual cost price. An exception to this general theory is the following, quoted from Paul Joseph Esquerre*:

"The inventory of a trading concern should be valued at cost. It has been held that it is proper to compute it on the basis of the market value, if such a value is smaller than cost; but it is generally denied that a market value higher than cost can be used. If the lower value is allowed, there is no reason why the higher one should not be. There is, however, a good reason why market values should not be used at all. Accounting is not interested in what would have happened 'if', but in what has actually happened; and since the goods unsold were purchased at a certain price, the profits realized are to be measured by comparing that price with the proceeds. To reduce the inventory to a value lower than cost, is to add to the cost of the goods sold during the period; and to raise the inventory to a value greater than cost, is to reduce the cost of the goods during the period. In either case, the result is contrary to the truth."

A quotation from William R. Basset's "Accounting as an Aid to Business Profits" is to be contrasted with the above:

"The rules for values are arbitrary and, to some extent, unreasonable, but they are accepted everywhere and bankers look askance at any departure from them. Here they are:

1. "Value at cost.

2. "If the cost is above the market, then value at the market.

3. "If the cost is below the market, do not raise the values—keep them still at cost.

"It is not logical to bring down cost to the market and at the same time refuse to raise the inventory if the market is above the cost; but the procedure is so established that it should not be departed from. And also it does prevent a mere bookkeeping profit from appearing as an actual profit. An excellent practice is to value according to the above rules and attach a

*Author of "Applied Theory of Accounts."

footnote showing the increased values according to market prices. This gives the necessary information without inflation."

The latter seems to be the more general procedure and throughout this course there will be noted the fact that all inventories have been taken at cost or market value, whichever is the lower.

In some cases there would seem to be just cause for taking an inventory at a price exceeding the cost price. For instance, in determining the value of stock on hand at the time of the sale of a business, the inventory may be taken at market price, even though it be above cost price. In any event, if an auditor were asked to certify to a statement in which the inventory had been taken at a price higher than cost price, the fact should be noted either in the Balance Sheet or as a footnote to it.

In a manufacturing business the inventory will usually be subdivided into three parts as follows:

1. Raw materials.
2. Goods in process.
3. Finished goods.

The method of taking the inventory will not vary from the standpoint of valuation from that of a trading concern. All stock regardless of what stage it may be in should be priced at cost or market, whichever may be the lower. The cost price of raw materials can always be determined from the purchase records. The price of goods in process will not be so easily determined. During the process of manufacturing the cost increases until at the time the goods are finished they represent to the manufacturing concern the same as merchandise does to the trading concern. In other words, the finished goods of the manufacturer is the stock-in-trade. There are three items of cost to consider in determining the inventory value of goods in process:

1. Cost price of raw materials consumed.
2. Direct labor.
3. Factory overhead or manufacturing expenses.

The inventory value of finished goods will be the same as the cost of production. The cost of production here is to the manufacturer what the cost of merchandise purchased is to the merchant.

Turnover. The rate of "turnover" is the number of times a firm "turns" its stock during the year. For instance, when a stock of goods has been purchased and has been sold, it is known as a turnover; if the money is reinvested in another stock of goods and this is disposed of within the year, there is said to have been a second turnover. The process of determining the rate of turnover seems to vary with different authorities. Montgomery says:

"To ascertain the turnover, take the starting inventory, add the purchases or cost of manufactured goods, and deduct the inventory at the end; divide the total by the starting inventory. The calculations are based upon a normal inventory.

The result will be the number of times the capital invested in stock-in-trade has been turned over during the period."

It will, therefore, be seen that according to Mr. Montgomery's idea the turnover would be found by dividing the COST OF SALES by the beginning inventory, provided that inventory is a normal inventory. In order to determine whether it is a normal inventory or not, it would be best to average the inventory for a period of years If the inventories for a period of, say, five years were used in determining the average, and it approximated the same as the inventory for the present year, then it will be seen that it constitutes a normal inventory. This seems to be the more uniform practice. However, it is well to give consideration to what others have to say on the matter. Walton says:

'If we adopt working capital as the basis of the turnover the difficulty disappears, because the amount of working capital is indicated in the Balance Sheet, if we adopt the definition of working capital as that part of the proprietorship not tied up in fixed assets, in other words, the excess of current assets over current liabilities. Except as affected by the slight increase due to accumulating undistributed profits, it remains the same throughout the entire period and therefore affords a stable basis of comparison.

"The use of working capital as the basis of turnover is logical because it was put in the business for the purpose of being turned over as rapidly as possible, because it is virtually constant, and because it represents all the elements concerned in the turnover—not only the stock-in-trade, but also the accounts and notes receivable that are the means by which the turnover is effected."

The difficulty with this theory lies in determining the meaning of the term "working capital." H. R. Hatfield* says:

"Working capital has long had a specific meaning as a collective term for what are often called quick assets, e. g., cash, accounts receivable, perhaps merchandise, etc."

H. C. Bentley† says: "Working capital is the excess of quick assets over quick liabilities."

Walton considers Bentley's definition as the correct one. At any rate, he further says: "It is in my opinion the accounting view of what capital is." Therefore, the whole problem is narrowed down to the question as to whether we are to consider the normal inventory as the basis of a turnover, or whether we are to consider the working capital as the basis. It is unfortunate that accountants cannot find some means for arriving at uniformity in practice with reference to the more important accounting principles.

Determining the Value of Merchandise Destroyed by Fire. All business men anticipate the possibility of a fire, but few give thought to how they will collect their insurance. Frequently settlement must be made upon a basis satisfactory only

*Author of "Modern Accounting."

†Author of "Science of Accounts."

to the insurance company for the reason that the business man is unable to prove what has been destroyed and the value thereof.

A properly authenticated Balance Sheet certified to by a public accountant is a material aid in the adjustment of claims as has often been demonstrated in practice. Where an inventory is not available at the time of fire, the claim is usually adjusted by using the "gross trading profit" test. The average gross trading profit in prior periods is used as the basis of determining the cost of sales. Deduct the average gross trading profit from sales and the result is the cost of sales. Having determined this, take the last known or recorded inventory, add purchases to date of fire and deduct cost of sales. The result is the inventory at time of fire. If a perpetual inventory has been maintained and the last Balance Sheet prepared by a Certified Public Accountant, no compromise with the insurance company need be made, but allowance for the full amount of the claim may be insisted upon.

2. AUDITING THEORY

Quoting from Federal Reserve Bulletin:

Inventory Must Include Only Goods Owned. "Under this caption must be included only stocks of goods owned and under control of the owner. Stocks are often hypothecated and if this is the case the fact should be stated on the Balance Sheet.

Beginning Inventory Must Be Verified. "Inasmuch as the accuracy of the Profit and Loss account is absolutely dependent upon the accuracy of the inventories of merchandise at the beginning and end of the period under review, this part of the verification should receive special attention. When a Balance Sheet audit is being made for the first time, the inventory at the beginning of the period should receive as much attention as that at the end, and the auditor should take every precaution to satisfy himself that both inventories were taken on the same basis.

Audit Program. "An acceptable program of audit for inventories is as follows:

Stock Sheets. "(1) Secure the original stock sheets if they are in existence and carefully test the typewritten copies with them and with tickets, cards, or other memoranda that show the original count.

Inventory Certificate. "(2) See that the sheets are certified to or initialed by the persons who took the stock, made the calculations and footings, and fixed the prices, and satisfy yourself that they are dependable and responsible persons. Obtain a clear and detailed statement in writing as to the method followed in taking stock and pricing it; also a certificate from a responsible head as to the accuracy of the inventory as a whole.

Footings and Extensions. "(3) A thorough test of the accuracy of the footings and extensions should be made, especially of all large items.

Discrepancies. "(4) The inventories should be compared with the stores ledger, work in progress ledgers and finished product records and stock records as to quantities, prices and values, and any material discrepancy should be thoroughly traced.

Book Inventory. "(5) Where stock records are kept and no physical inventory is taken at the time of the audit, ascertain when the last physical inventory was taken and compare it with the book records. If no recent comparison is possible, select a few book items of importance and personally compare with the actual stock on hand.

Physical Inventory. "(6) Where no stock records are kept, a physical inventory should be taken preferably under the general direction of the auditor. After the inventory is completed, he should apply the same tests to verify its accuracy as if the inventory had been taken before his arrival upon the scene.

Inadequate Cost Systems. "(7) When the cost system of a company does not form a part of the financial accounting scheme there is always a chance that orders might be completed and billed, but not taken out of the work in progress records. Especially is this the case when reliance is placed on such records to the extent that a physical inventory is not taken at the end of the period to verify the information shown therein. In these cases the sales for the month preceding the close of the fiscal period should be carefully compared with the orders in progress as shown by the inventory, to see that nothing that has been shipped is included in the inventory in error. Cost systems which are not coordinated with the financial accounts are unreliable and frequently misleading. Special attention should be called to every case in which the cost system is not adequately checked by the results of the financial accounting.

Goods in Transit. "(8) Ascertain that purchase invoices for all stock included in the inventory have been entered on the books. Look for post dated invoices and give special attention to goods in transit.

Consigned Goods. "(9) See that nothing is included in the inventory which is not owned but is on consignment from others. If goods consigned to others are included, see that cost prices are placed thereon, less a proper allowance for loss, damage, or expenses of possible subsequent return. This does not include goods at branches, as the valuing of such stocks will be governed by the same principles as apply at the head office.

Goods Awaiting Shipment. "(10) Ascertain that nothing is included which has been sold and billed, and is simply awaiting shipment.

Legitimate Costs. "(11) If duties, freight, insurance, and other direct charges have been added, test them to ascertain that no error has been made. Duties and freight are legitimate additions to the cost price of goods, but no other items should be added except under unusual circumstances.

Obsolete Stock. "(12) As a check against obsolete or damaged stock being carried in the inventory at an excessive valuation, the detailed records for stores, supplies, work in progress, finished products, and purchased stock in trade, should be examined and a list prepared of inactive stock accounts, which should be discussed with the company's officials and satisfactory explanations obtained.

Cost or Market Price. "(13) The auditor should satisfy himself that inventories are stated at cost or market prices, whichever are the lower at the date of the Balance Sheet. No inventory must be passed which has been marked up to market prices and a profit assumed that is not and may never be realized. If the market is higher than cost, it is permissible to state that fact in a footnote on the Balance Sheet.

Average Price Used. "(14) It may be found that inventories are valued at the average prices of raw materials and supplies on hand at the end of the period. In such cases the averages should be compared with the latest invoices in order to verify the fact that they are not in excess of the latest prices, and also with the trade papers, when market prices are used, to see that they are not in excess of market values.

Reasonable Quantities. "(15) Make an independent inspection of the inventory sheets to determine whether or not the quantities are reasonable, and whether they accord in particular instances with the average consumption and average purchases over a fixed period. Abnormally large quantities of stock on hand may be the legitimate result of shrewd foresight in buying in a low market, but may, on the other hand, arise from serious errors in stock taking.

Gross Profit Test. "(16) Always attempt to check the totals by the 'gross profit test' and compare the percentage of gross profit shown with that of previous years. In a business where the average gross profit remains fairly constant this test is a dependable one, because, if the rate of gross profit is apparently not maintained and the discrepancy can not be satisfactorily accounted for by a rise or fall in the cost of production or of the selling price, the difference will usually be due to errors in stock taking.

Testing the Cost System. "(17) In verifying the prices at which the work in progress is included in the inventory, a general examination and test of the cost system in force is the best means of doing this work satisfactorily. In a good cost system little difficulty will be found with the distribution of the raw materials, stores, and pay roll, but the distribution of factory overhead cost is one that should receive careful consideration, the main points to be kept in view being:

"(a) That no selling expenses, interest charges, or administrative expenses are included in the factory overhead cost.

"(b) That the factory overhead cost is distributed over the various departments, shops, and commodities on a fair and equitable basis.

Cost vs. Selling Price. "(18) No profit should be included in the price of finished products or stock-in-trade. The price list should be examined to see that the cost prices of stock are below the selling prices after allowing for trade discounts, and, if they are not, a reserve should be set up on the Balance Sheet for this loss. If the company takes immediate steps to increase the selling price, however, the amount of this reserve may be limited to the loss on goods which may have been sold since the close of the period to the date of the discovery.

Profits on Partial Shipments. "(19) In the case of companies manufacturing large contracts it is frequently found necessary to make partial shipments thereof. The question then arises as to whether it is permissible to include the profits on these partial shipments in the Profit and Loss account. As a matter of fact, it is evident that the actual cost can not be known until the order is completed. It may be estimated that a profit will ultimately be made, yet unforeseen conditions, such as strikes, delays in receiving material, etc., may arise to increase the estimated cost. It is better not to include the profits on partial shipments, but information of this character which may have its influence in the decision of the banker upon a proposed loan may properly be laid before him. Of course, an exception should be made in cases where the profit on the partial shipments largely exceeds the selling price of the balance of the order.

Contract Prices. "(20) The selling prices for contract work in progress should be ascertained from the contracts, and where it is apparent that there will be a loss on the completed contract a due proportion of the estimated loss should be charged to the period under audit by setting up a reserve for losses on contracts in progress.

Unsalable Stock. "(21) If a company has discontinued the manufacture of any of its products during the year, the inventory of such products should be carefully scrutinized and, if unsalable, the amount should be written off.

Charges to Fixed Assets Must Not Be Included. "(22) The inventory should be scrutinized to see that no machinery or other material that has been charged to plant or property account is included therein.

Partial Deliveries. "(23) Partial deliveries received on account of purchase contracts for material, etc., should be verified by certificates from the contractors, both as to quantities and prices.

Advance Payments. "(24) Advance payments on account of purchase contracts for future deliveries should never appear in an inventory, but be shown on the Balance Sheet under a separate heading.

Discounts. "(25) Trade discounts should be deducted from inventory prices, but it is not customary to deduct cash discounts. However, this may be done when it is the trade practice so to do.

Turnover. "(26) While the inventory is being verified, the auditor should ascertain the aggregate sales for the last year. If the turnover has not been rapid, it may be due to a poor stock of goods. Some business men dislike to sell below cost and would rather accumulate a big stock of old goods than dispose of the old and unseasonable stock at a sacrifice. The usual outcome is that the stock becomes unwieldy and funds are lacking to purchase new goods. The inventory and the gross sales may, therefore, have a direct connection.

Interest Not a Part of Cost. "(27) It may be well to reiterate that interest, selling expenses, and administrative expenses form no part of the cost of production, and therefore should not be included in the inventory in any shape."

3. AUDITING PROCEDURE

The inventory of December 31, 1918, was checked as to extensions and footings. Also, tests were made by actual count of some of the items listed. The secretary of the Company certified that the inventory represented only the materials and goods in process and on hand at the plant and in store as ascertained by actual count. The total of the inventory of materials and work in process amounted to $55,000.00; finished stock $80,000.00.

It would have been much better had the raw materials and the work in process been kept separate, but in this case it seems that there were practically no raw materials on hand other than those in process of manufacture, consequently there is no separate item for raw materials. In verifying the value of the work in process, it was found that the actual cost price of the raw materials consumed, plus the direct labor and the overhead factory expenses had been added. The item of $2,875.00, which represents the factory pay roll accrued, but not paid, was found to represent direct labor which had not been included in the value of the work in process, as valued at $55,000.00.

In arriving at the value of the finished goods, there was taken into consideration the actual cost of production which included the overhead factory expenses, but no selling expenses, interest charges nor administrative expenses were included in the factory overhead cost. A number of items listed were checked by an actual count and found to be correct. The inventory was verified by J. I. King, junior accountant. All extensions and footings were verified.

4. INCOME TAX PROCEDURE

Inventories shall be Taken Upon such Basis as may be Prescribed.

> **Income Tax Law.** Section 203. "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Basis of Inventory Valuations. (T. D. 2609, December 19, 1917.) "For the purpose of income and excess profits tax return, inventories of merchandise, etc., and securities, will be subject to the following rules:

"A. Inventories of supplies, raw materials, work in process of production and unsold merchandise must be taken either (a) at cost, or (b) at cost or market price whichever is lower, provided that the method adopted must be adhered to in subsequent years unless another be authorized by the Commissioner of Internal Revenue.

"B. A dealer in securities who in his books of account regularly inventoried unsold securities on hand either (a) at cost or (b) at cost or market price whichever is lower, may, for the purposes of income and excess profits taxes, make his return upon the basis upon which his accounts are kept, provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that that method must be adhered to in subsequent years unless another be authorized by the Commissioner of Internal Revenue.

"C. Gain or loss resulting from the sale or disposition of assets inventoried as above must be computed at the difference between the inventory value and the price or value at which sold or disposed of.

"In all other cases inventories must be taken at cost or at value as of March 1, 1913, as the case may be."

Need of Inventories. (Art. 1581. Reg. No. 45, 1918.) "In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption or use in productive processes, together with all finished or partly finished goods. Title to the merchandise

included in the inventory should be vested in the taxpayer and goods merely ordered for future delivery and for which no transfer of title has been effected should be excluded. The inventory should include merchandise sold, but not shipped to the customer at the date of the inventory, together with any merchandise out upon consignment, but if such goods have been included in the sales of the taxable year, they should not be taken in the inventory. It should also include merchandise purchased, although not actually received, to which title has passed to the purchaser. In this regard care should be exercised to take into the accounts all invoices or other charges in respect of merchandise properly included in the inventory, but which is in transit or for other reasons has not been reduced to physical possession.

Valuation of Inventories. (Art. 1582. Reg. No. 45, 1918.) "Inventories should be valued at (a) cost or (b) cost or market, whichever is lower. Whichever basis is adopted must be applied to each item and not merely to the total of the inventory; that is, if for instance basis (b) is adopted, the value of each item in the inventory will be measured by market if that is lower than cost, or by cost if that is lower than market. A taxpayer may, regardless of his past practice, adopt the basis of cost or market, whichever is lower, for his 1918 inventory, provided a disclosure of the fact and that it represents a change is made in the return. Thereafter changes can be made only after permission is secured from the Commissioner. Inventories should be recorded in a legible manner and properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased."

Inventories at Cost. (Art. 1583. Reg. No. 45, 1918). "Cost means:

"(1) In the case of merchandise purchased, the invoice price less trade or other discounts except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

"(2) In the case of merchandise produced by the taxpayer, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital whether by way of interest or profit. In any industry in which the

usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.

Inventories at Market. (Art. 1784. Reg. No. 45, 1918.) "Market means the current bid price prevailing at the date of the inventory for the particular merchandise, and is applicable to goods purchased and on hand and to basic materials in goods in process of manufacture and in finished goods on hand, exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory. Where no open market quotations are available the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available to him, such as specific transactions in reasonable volume entered into in good faith, or compensation paid for cancellation of contracts for purchase commitments. The burden of proof will rest upon the taxpayer in each case to satisfy the Commissioner of the correctness of the prices adopted. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market has been established during the succeeding year, a claim may be filed for any loss sustained in accordance with the provisions of section 214 (a) (12) or section 234 (a) (14) of the statute.

> **Adjustment of Inventories After Close of Taxable Year. Income Tax Law.** Sec. 214. (a-12) [Individuals.] (a-14) [Corporations.] "At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition resulting from any material reductions (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid

by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the taxes imposed by this title and by Title III the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the taxes imposed by this title and by Title III for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252."

Inventories Prescribed in Certain Cases. (Reg. No. 33, 1918, ¶353.) "Gross income for the purpose of returns of manufacturing companies shall consist of the total sales plus the inventory at the end of the year less the sum of the cost of goods or materials purchased during the year and the inventory at the beginning of the year."

(Reg. No. 33, ¶354.) "For the purpose of returns gross income of mercantile companies shall consist of the total sales plus the inventory at the end of the year less the sum of the cost of goods purchased during the year and the inventory at the beginning of the year."

A. THEORY QUESTIONS

1. What duties and responsibilities has an auditor in connection with inventories of goods on hand?
C. P. A. Me. and Ore.

2. What is turnover and of what use should an auditor make of it in an audit of a merchandising business?
C. P. A. Ind.

3. A manufacturing company purchased a large stock of material during the year at low prices, but at the time of the annual inventory values had abnormally increased. How, in your opinion, should the inventory and loss and gain be shown on the books? C. P. A. Mich.

4. You are asked by a client to treat inventories at the time of closing the books. Should they be figured at cost or market price or otherwise? Is the common, old-fashioned method of adding the inventory of merchandise on hand to the credit side of the Merchandise account before closing the books, theoretically correct? Explain fully. C. P. A .Mich.

5. Explain what is understood by a "book inventory" and indicate in what circumstances and for what purposes you would consider such a record to be of use in a manufacturing business

(a) For current information.
(b) For use in the preparation of interim statements of accounts.
(c) For use in the preparation of final yearly or half-yearly accounts.

Assuming your client decided to rely entirely upon such book records, what steps should be taken to guard their accuracy?
Inst. Ex. 1918.

6. An inventory is submitted to you certified by the manager of a business. Mention some of the principal steps you would take to confirm the correctness of the inventory figure appearing in the Balance Sheet. Inst. Ex. 1917.

7. A company which keeps no perpetual inventory records but takes an inventory annually on December 31, suffers a fire loss on March 1. How would you proceed to compute the inventory on hand at that date? Inst. Ex. 1917.

8. "Inventory of merchandise should be carried at cost or market, whichever is lower." Do you assent to this proposition? Can you suggest circumstances in which you would approve a departure therefrom? Would you be influenced by events or conditions subsequent to the date of closing the accounts? Give reasons. Inst. Ex. 1918.

B. ACCOUNTING PROBLEMS.

1. From the following particulars you are required to determine the value of the merchandise on hand:

Inventory at beginning of period..........	$75,000.00
Purchases..............................	200,000.00
Wages..................................	65,000.00
Freight Inward.........................	3,000.00
Gross Profit...........................	56,780.20
Discount on Sales......................	4,540.00
Sales..................................	360,784.80
Discounts Received on Purchases..........	1,760.00

C. P. A. Ind.

2. Arrange the following in a Balance Sheet for presentation to a banker.

Furniture and Fixtures.........	$15,000.00	
Stock of Merchandise at cost...	50,000.00	
Accounts Receivable...........	35,000.00	
Officers' Accounts.............	30,000.00	
Bonds Owned.................	10,000.00	
Capital Stock..................		$75,000.00
Accounts Payable.............		20,000.00
Trade Notes Payable..........		40,000.00
Surplus......................		5,000.00
	$140,000.00	$140,000.00

C. P. A. Ill.

3. You are asked to certify to the Balance Sheet of a certain company. Upon investigation, you find that the inventories have been priced at cost, although the market prices at the closing date were 10% lower on iron and 5% higher on wood. At the date of your report the market on iron had risen to 5% above cost, and the market on wood had fallen to 15% below cost.

How would you dispose of these items in the Balance Sheet?

C. P. A. Ill.

4. You are called in as a public accountant to assist a firm in the preparation of a Balance Sheet as at December 31, 1915, and in the balancing of the books. After examination you find the following facts:

(1) On January 3 three items, amounting to $50,000.00 in the aggregate, were received in cash, but were entered as at December 31, 1915. No Cash account is kept in the general ledger.

(2) An item was posted to the credit of an account in the sales ledger from the cash book as $5,050.00 instead of $50.50. A Sales Ledger control account is kept in the general ledger.

(3) The Petty Cash fund is kept on the imprest system. On December 31, 1915, a voucher covering expenditures to date was passed and entered in the Voucher Register. The check in payment thereof was not entered in the cash book until January 3, 1916.

(4) A building had been destroyed by fire, and the insurance recovered had been credited to the asset account and the cost of replacement had been debited thereto.

(5) An item was posted to the debit of the Interest account in the general ledger from the journal as $3.03. It should have been $303.00.

(6) Sales aggregating $25,000.00 were entered on the books as at December 31, 1915, but the goods were not all delivered until January 25, 1916.

Indicate what adjustments you would make of the books or of the accounts for the purpose of statement on the Balance Sheet. Give journal entries. C. P. A. Ill.

5. It is generally conceded that merchandise inventories should be calculated on "cost" prices, but in practice there are found many differences in the method of determining the cost price.

State whether or not the following items should be regarded in arriving at this cost, giving your reason in each case:

Cash discounts.
Trade discounts.
Freight inward (on goods bought).
Freight outward (on goods sold).
Rebates and premiums, such as are found in connection with the tobacco business.
Drayage and handling (inward).
Packing and draying (outward). C. P. A. Fla.

C. INCOME TAX QUESTION

Should an individual who conducts a grocery, dry goods, clothing, or farm implement business, or any other business which requires that a stock be carried, take an inventory at the close of each taxable year and take such inventories into consideration in arriving at his net income from business? Explain.

Chapter Eight

THE TRIAL BALANCE

In Chapter Three there was a discussion of the general ledger showing its control in an accounting system, also a discussion of the Trial Balance. The discussion there, however, was quite brief. It is intended here to show how an auditor would proceed to verify all the items in the Trial Balance.

The Bookkeeper's Trial Balance. There is no reason why an auditor should not accept a Trial Balance offered him by the head bookkeeper at the beginning of the audit, but that does not mean that he need not verify the items listed thereon. If he were to refuse the Trial Balance offered him, the chances are the bookkeeper would be offended and it might lead to his opposition instead of his cooperation during the audit. It would seem to be better practice, however, to prepare your own Trial Balance even though you have been furnished with one by the head bookkeeper or someone else in the employ of the client. Trial Balances may be made of the subsidiary ledgers as well as of the general ledger, provided summary or adjustment accounts are maintained in the subsidiary ledgers.* Usually, however, no such accounts are maintained in the subsidiary ledger, therefore, the only way a Trial Balance can be taken is to check the list of accounts taken from the subsidiary ledger with the controlling account in the general ledger.

Advantages of an Auditor Preparing His Own Trial Balance. The auditor will find that he has a splendid opportunity to become familiar with the details of the accounting system while preparing his Trial Balance. He cannot help, in going over all the accounts, thinking about them and while making the necessary calculations to determine the correct balances, build up in his mind as he goes along a general knowledge of the organization as a whole.

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*Any subsidiary ledger may be made self-balancing by means of a summary or adjustment account. This account is set up in the subsidiary ledger and is an exact duplicate of the controlling account in the general ledger except that the sides of the account are reversed so that the subsidiary ledger account has for its debits the credits of the general ledger account, and for its credits the debits of the general ledger account.

There is no theory or principle of debit and credit involved in this, the device is simply introduced in order that the ledger may provide an internal proof of its correctness. Therefore, the total of the balances of the individual accounts in the subsidiary ledger will be offset exactly by the opposite balance of the one additional account, and the ledger then is said to be self-balancing.

This is not often carried out for the reason that it is considered better practice and more desirable for the controlling account to be in the hands of another person who thus has a check upon the bookkeeper's work.

A Set of Books is not Ready to be Audited Until in Balance. Some bookkeepers and business men think that an auditor by some sort of magic should be able to detect all mechanical errors in bookkeeping and arrive at a correct Trial Balance in a few minutes time. However, the fact is that it is no part of an auditor's duty to locate an error or errors in a Trial Balance unless he has been employed specifically to do so. An auditor who accepts an engagement to perform an audit, and who on beginning his work finds that the books are not in balance, should report the matter to his client and lay the facts before him. He can, of course, undertake to do the necessary clerical work in order to locate the errors in the accounts so as to obtain a Trial Balance, but to do so without previous arrangement with the client is liable to result in difficulties when the bill for services is presented. Anyone who spends his time in ordinary clerical work is hardly to be considered a professional auditor and it would seem to be better to permit the bookkeeper to locate his own errors and obtain a Trial Balance before beginning the audit.

Remuneration Basis. In this connection it is well to point out that audits are made under two classes of remuneration: those in which the remuneration is based on a per diem basis; and those in which it is being done under a contract specifying a certain sum. If the work is being done under a contract and the time necessary to do the work has been previously estimated, it would certainly be foolish to put in a lot of time finding ordinary clerical mistakes in bookkeeping, and to do so may result in a loss on the engagement. If the work is being done on a per diem basis, the auditor is apt to become involved in disagreeable discussions with the client because of the length of time spent in performing the ordinary clerical work of the bookkeeper. Consequently, let us point out again that the books should be in balance before the auditor begins his work, and if they are not in balance, the bookkeeper should be given an opportunity to locate his own errors and obtain a Trial Balance, after which, the auditor may proceed with his work in accordance with the instructions given hereinbefore and hereinafter.

The Trial Balance as a Part of the Working Sheet. The Trial Balance is not a financial statement, neither is it a test as to the accuracy of the bookkeeping work. It is merely a list of the balances of the accounts remaining open in the ledger. Therefore, it is nothing more than a surface indication that the books are in balance and that an equilibrium has been maintained between the debits and credits. The professional auditor usually prepares what is known as a "Working Sheet", the Trial Balance simply being a part and is represented by the first two columns. The Working Sheet, in addition to containing

columns for a Trial Balance, should provide columns for adjustments, columns for the nominal accounts only, and columns for the real accounts only. The first two columns show the Trial Balance taken at the close of the period, but before the adjustments have been made. The adjustment columns show all the adjustments and corrections made after the Trial Balance is taken and before the statements and report are prepared. The columns for nominal accounts show the profits and losses for the period. The columns for real accounts show the assets and liabilities as at the end of the period under audit.

The accounts should be arranged on the Working Sheet in such a manner as to provide the most information and so as to make it most convenient for the preparation of the report for the client at the completion of the audit. The accounts need not, therefore, be arranged in the same order as the arrangement of the accounts in the ledger. (The Working Sheet will be explained in detail in a later chapter.)

Procedure in Taking a Trial Balance. First, prove each account by footing both sides of the account and substracting the two footings so as to verify the balance. It does not matter whether this has been done by the bookkeeper previously or not. The auditor should make his own verification independent of that of the bookkeeper.

Second, every page in the ledger should be examined. Experience will prove that some bookkeepers have peculiar ideas with regard to the arrangement of their accounts, consequently blank pages will be found here and there throughout the ledger and if every page isn't examined, accounts might be omitted.

Third, subsidiary and memorandum accounts may be found in the general ledger. For instance, one ledger may be used. It may be divided into sections; the first section may contain all the assets and liabilities together with controlling accounts for customers and creditors; the second section of the ledger may contain accounts with customers; and the third section, accounts with creditors. On the other hand, it is not infrequently found that subsidiary ledgers are kept, but no controlling accounts maintained in the general ledger. The bookkeeper when preparing his Trial Balance simply makes a schedule from the subsidiary ledgers and uses the total amount in his Trial Balance.

Fourth, some bookkeepers seem to have the idea that a Cash account need not be kept in the general ledger simply because a cash book is kept. While it is certainly poor practice to eliminate the Cash account in the ledger, yet such will often be the case, consequently a Trial Balance cannot be obtained unless the cash balance is first obtained from the cash book and included in the Trial Balance. The only sound accounting theory is that a general ledger should balance independently of all the other books of account. Any argument contrary to these principles is certainly contrary to good accounting practice.

Fifth, the first Trial Balance is usually taken after the posting has been done at the end of the period and before any adjustments have been made. The auditor will have to be on the lookout for items posted to the accounts after the bookkeeper completed his Trial Balance. This is sure to happen when an audit is made at a date later than the end of the period under audit.

Quoting From The Federal Reserve Bulletin:

"Trial Balances of the general ledger, both at the beginning and end of the period under review, should be prepared in comparative form and checked with the ledger. The items in the Trial Balances should be traced into the Balance Sheets before the assets and liabilities are verified, to prove, among other things, that no 'contra' asset or liability has been omitted from the accounts, that the assets and liabilities have been grouped in the same manner at the beginning and at the end of the period, and also that the Balance Sheets are in accordance with the books. The disposition of any general ledger assets and liabilities that may have been scrapped, sold, written off, or liquidated during the period under review should be traced and noted in the working papers. Furthermore, a general scrutiny of the general ledger should be made to see that the accounts, if any, that have been opened and closed during the year have no bearing on the company's financial position at the close of the fiscal period."

ITEMS NOT ON TRIAL BALANCES

The following quotation is taken from "Duties of the Junior Accountant" by Reynolds and Thornton, published by the American Institute of Accountants:

> "Among the items which must be taken into account, but may not be on the books, are some which the junior should detect and take up in every instance. These are omissions from interdepartmental balances and balances between subsidiary companies, goods in transit and cash in transit.
>
> "It is quite common to find Trial Balances, apparently in order, which contain among 'accounts receivable' amounts due from subsidiary companies or from departments of the same company, and among 'accounts payable' corresponding entries, but for differing amounts. Wherever a Trial Balance shows any balance due from one department to another, from one subsidiary to another or from either to the principal company the auditor must see that the entry is exactly offset by a corresponding item in the accounts of the subsidiary or department concerned. If a department carry as an asset an amount due from another department and the

second department does not show any liability in respect thereto the accounts as a whole contain an inflation of net assets, and the auditor can so easily find such an error that no excuse for failing to do so will be admitted.

"Where subsidiary companies are concerned the detection of such errors is equally easy if the auditor has access to books of subsidiaries.

"The detection of omission from inventories of goods in transit and of cash in transit are dealt with under appropriate headings herein.

"To sum up this section, let the auditor, whenever he has access to books showing both sides of a transaction, compare the two entries and agree the resulting balances."

Results of the Senior's Checking the Trial Balance. The senior checked the Trial Balance himself because of the opportunity it offers to gain an insight into the nature of the organization and of the business conducted. His working papers show the following:

First, he found that the information referred to in the audit of accounts receivable in Chapter Six is correct. The total of the debit balances of the customers' accounts in the sales ledger amount to $84,721.50. The total of the credit balances amount to $3,034.50. The difference between the debit and credit balances is equal to the balance of the controlling account in the general ledger, amounting to $81,687.00.

Second, he reports an offsetting error in footing the accounts. The debit side of the account with Salary Advances to Salesmen was overfooted $30.00, and the account with Sales was overfooted $30.00 on the credit side.

Third, he found an error in principle. An expenditure amounting to $215.00 for a new machine in the factory was charged to Tools and Implements instead of to Machinery. Investigation shows plainly that it should be a charge to the Machinery account.

Fourth, he notes an error in the working papers of J. I. King with reference to listing of notes receivable. Reference to page 69 of Chapter Five will show that Mr. King listed the notes receivable. His papers show that two notes were discounted, December 1, 1918. If that were the case, then the face of those notes should either have been credited to the Notes Receivable account or to an account with Notes Receivable Discounted. Inasmuch as the Trial Balance does not indicate an account in the general ledger with Notes Receivable Discounted, it is apparent, even without an examination, that no such an account is maintained. Therefore, notes receivable discounted were credited to the Notes Receivable account, consequently, would not be included in the total of notes receivable on hand and would not

appear as a part of the balance of that account in the Trial Balance. The Trial Balance prepared by Mr. Shields and handed to the senior at the beginning of the audit lists notes receivable, in amount $12,906.00. The Working Sheet of the junior shows the same total, but he makes no comment relative to the notes receivable discounted except to say that they were verified at the bank.

Mr. King states that the error is in the date of discount. He claims that he made an error in indicating "December 1, 1918" as the date of discount. It should have been "January 1, 1919". He says the error was due to a mistake in copying his report.

Advice to Juniors. It is in order here to point out the advisability of using the utmost caution in the preparation of all working papers and reports. Carelessness is not excusable. Accounting firms employ extra juniors during the busy season. Those juniors who are competent and accurate in their work are the ones likely to be retained permanently, while those incompetent, inaccurate and careless in their work are the ones who will be the first to be let go. Seniors frequently are asked to name the juniors they wish to work with them on certain engagements. The mere fact that certain juniors are asked for frequently by the seniors is evidence as to the quality of their work and is in itself a recommendation. While a junior who is not asked, but who is used only because no one else is available, is certainly at fault in some manner and he needs to take an inventory of himself and determine his weakness. Mr. King, the junior mentioned above, may or may not be at fault, the fact remains, however, that he made an error although he states that he simply erred in copying his report from hastily written notes made on the day of the audit.

READING THE MINUTES

Without a doubt the minutes should be read as early after the audit is begun as may be practical. They will give an authoritative insight into the organization that can not be gained in any other way; consequently, the auditor will be prepared to do more intelligent work in completing the audit. He will know whom to consult in case any further information is desired because the minutes show who the officers are and what their duties and responsibilities are.

The minutes of the stockholders, board of directors, the executive committee, and any special committees should be read. The articles of incorporation will usually be embodied in the minutes of the stockholders, but if not, the auditor should ask for a copy of the articles or for a certificate of incorporation. These are sometimes known as the charter. The auditor should note in his working papers the exact name of the corporation, the date the certificate was filed, the authorized capital stock

showing the kind of stock, the par value of each share and the number of shares, the names of the incorporators, and any other information likely to be of benefit in the preparation of the report. It is better to write down more than will ever be used than to find when making the report that certain information is necessary and that he failed to make note of it in his working papers. The importance of this statement will be understood when it is considered that frequently an audit is made in a distant city, while the report will be prepared in the office. The audit might be made in Seattle and the report might be written in Boston. Therefore, it would be quite embarrassing to learn that all the information desired had not been obtained.

The minutes of the stockholders should be examined with regard to election of officers, compensation of officers, bond of the treasurer, contracts with the manager and other employees, any special contracts that may exist, resolution fixing the value of property purchased and the rates of depreciation, etc. The minutes of the board of directors should be examined for additional information.

An executive committee often exists in a corporation. It may be composed of three or more members of the directors and its purpose is to facilitate certain features of the work. Financial matters are usually looked after by this committee, and it often outlines the financial program and has authority to make appropriations, etc.

In the case of a corporation the by-laws will often furnish additional information and should undoubtedly be read. One cannot become too well acquainted with the organization and its details.

The author had an experience that may be of interest to some. He was employed by a man conducting a milling business to install a system of accounts involving a cost system. Preliminary to the installation of the system of accounts, he was asked to make a partial audit so as to insure a proper financial statement at the time the new system was installed. When employed by the client, he was informed that the business was a partnership, but when he asked for the copartnership agreement, he learned that none existed and finally obtained the information that the business was owned solely by the father of the client and that the client's position was that of a manager. Before proceeding further a conversation was held with the father and thereby, in addition to establishing the responsibility and authority of the client, information was secured that aided materially in opening the books after devising a system of accounts.

FIXED ASSETS

Having completed the audit of the current assets, the fixed assets will be taken up in the order in which they appear in the Trial Balance of The Blank Manufacturing Company as shown on page 50 of Chapter Four. The following accounts classified as fixed assets appear therein:

Land	$ 100,000.00
Buildings	150,000.00
Machinery	100,000.00
Tools and Implements	20,215.00
Horses, Wagons and Harness	15,000.00
Office Furniture	2,600.50

Following these accounts a discussion of depreciation will be given (see Chapter Ten). The object, of course, is to determine the true value of each asset, and the method the auditor used in arriving at the value.

Real Estate. The following discussion appears in 20th CENTURY BOOKKEEPING AND ACCOUNTING: (See page 87)

> "Real Estate is a technical term that is applied to immovable property which consists of land, buildings and other improvements which make the land valuable. Real estate may be purchased by a business (a) for a home, or (b) for speculation. When it is purchased as a speculation a separate account should be opened for each property owned.
>
> "The purchase price fixes the value of the real estate, and this value does not change except in the case of additional improvements. The value should not be increased by means of an inventory or appraisal for no profit can be realized until it is sold. A distinction should be made between the land and the buildings, because the buildings decrease in value owing to age and use, while the land does not. On account of this distinction their value should be separated at the time of purchase. Accountants recommend that separate accounts be kept with land and buildings. If only one account is kept, their separate value should be indicated by the use of the explanation column. In either case an account termed Building Expense and Revenue should be kept to record all expenses incident to the upkeep of the buildings, and income which may be derived from the rental of any portion of the building.
>
> "If the building is to be constructed on land pur-

chased for this purpose, the purchase price of the land together with any additional cost of grading and preparing it for the building, is charged to the Land account. Payments in connection with the construction of the building are charged to a Building Contract account. When the building is completed, the balance of this account is closed into a Building account. This is carried on the books as the value of the building, and the depreciation is based on it."

Many bookkeepers will keep an account with Real Estate or some similar term and the account will represent both the land and the buildings thereon. In fact, some of our bookkeeping texts still illustrate an account of this kind, consequently, there are thousands of students each year who are taught that land and buildings may be grouped in one account. To state that it is poor practice is putting it mildly. The accountant will always insist that land and buildings be kept separate in the accounts because of the difference in the nature of the items.

Esquerre' says:

"The components of the cost of plant land vary materially from those of investment land; the consideration of increases in market values, while of much importance in the case of the latter, is merely an incident in the case of the former, since the asset cannot ordinarily be sold without causing operations to come to an end, at least temporarily. On the other hand, buildings depreciate through wear and tear, while land does not; hence, if reserves are created for the depreciation of buildings, and applied for Balance Sheet purposes to Land and Buildings account, it is not possible to ascertain the book value of the asset which the depreciation affects.

"These accounting differences in the nature of the two values, land and buildings, would seem to be sufficient to cause the creation of two distinct accounts with them, and are generally so regarded."

In the preparation of a Balance Sheet the value of the land should always be listed as a separate item and should never be included with the value of the buildings for the reason that the depreciation on buildings does not affect the value of the land. Furthermore, good practice demands that the value of the land used in the business should be listed separately from land representing investments.

The Theory of the Land Account. This discussion is confined to land used in the business. It is the most permanent asset owned by a business enterprise. Land should appear in the Balance Sheet at cost, regardless of what the market value may be. In fact the market value is never known unless a sale is made. The object of the Land account is to show the cost,

therefore, it should be debited or charged with (a) the original cost; (b) the expenses incident to the purchase, such as cost of investigating the title, recording the deed, commissions to real estate agent, and any other expenses that clearly add to the cost of the purchase; (c) the cost of improvements that increase the value of the land, such as fencing, draining, leveling, filling in, building approaches, sidewalks, etc.

It is not always an easy matter to determine when expenditures are an actual improvement to the land. The auditor must examine carefully all charges to this account. Some think that interest may be charged to the account. For instance if money were borrowed at 6% to pay the expense of filling in, the interest will frequently be added to the cost of improvements. It is doubtful if it is good practice, in any event, to add interest to the cost of land, for to do so would mean that the Balance Sheet of the company who borrowed money to improve its real estate would show the land to be worth more than the land on the Balance Sheet of the company who paid cash for similar improvements.

Another matter that frequently requires consideration is the appreciation of land. If land is appraised at a higher value than cost price and its value has clearly increased, is it advisable to set up the supposed increase on the books? Sound accounting practice opposes such a procedure. To set up an appreciation in value would necessitate crediting an income account with the increased value. Such an increase would represent an unearned value and it is not likely that a company would care to pay income and excess profits taxes on such an extraneous profit. Furthermore, it would certainly be unwise to distribute such a profit.

When land is sold or otherwise disposed of, the account should be credited for the cost price of the land and not for the selling price. The profit or loss incident to the sale or disposition of land should be shown by a special nominal account. So far as is possible nominal and real accounts should be kept distinct. As many nominal accounts should be opened as are necessary to show the income and deductions from income, special profits and special losses.

The Theory of the Buildings Account. The object of this account is to show the cost of buildings on land owned by the business. The original cost is not often a matter of dispute. Buildings may be a part of real estate purchased, in which case a separate value should be placed on the land and buildings before they are recorded on the books. The total of this valuation should, of course, be the same as the purchase price of the real estate as a whole. Buildings may be erected under contract in which case the contract price should undoubtedly be set up as the cost. It would make no difference whether they were constructed under a straight contract or a "cost plus" contract. Buildings may be built by the firm itself. In this case the true cost should be set up on the books.

"If the construction is attended to by the concern itself, upon plans submitted by an architect, the cost of the building would include his fees, the expenses incurred in connection with permits, licenses, etc., the cost of insurance protection, the cost of all material used, the cost of labor expended on the foundations as well as on the structures, the cost of any outside labor which may have been required, the proportion of overhead expenses which apply to the construction, the interest on any moneys which have been borrowed for construction purposes and used therefore, up to the time when the new buildings were open for operation."

Some business men claim that they should be entitled to set up on the books the cost they would have had to pay an outsider to construct the buildings. Suppose a firm during an off-season decides to construct a building and by doing so saves a certain sum because it was able to construct the building cheaper than they could get an outsider to do the work. Would it not be correct to charge the building account with the sum it would have cost if the contract had been given to an outsider at an increased price? In this connection, note what Mr. Walton has to say:

"It is sometimes argued that the corporation would be entitled to charge its construction account with the same price that it would charge an outside customer. It is claimed that the use of its facilities in its own work would prevent its using them for outside work on which it would make a profit. It is more doubtful whether any concern would allow its own work to interfere with the taking of profitable outside contracts.

"No profit can be made except through a sale. In this case the reduced cost of the construction results in a saving and not in a profit, since there is no sale. In the end there will be no difference in the final effect on profits, whichever method is adopted. If the construction account is charged with the cost of the work plus the regular profit, the carrying of the building will be raised and the depreciation to be written off against the profits will be correspondingly increased. Therefore, if a profit is taken at first, it will be written off during the life of the plant, and will not be a permanent profit at all. On the other hand, if the work is charged out at cost, the annual depreciation will be less and the saving will be realized by the smaller yearly charge against profits for depreciation."

THE LAW OF REAL ESTATE

Fenneberg in his treatise on "Simplified Law" defines real property or real estate as follows: "Real property or real estate represents a definite portion of land including everything growing above the ground as well as all things hidden beneath the surface. Ownership extends to the center of the earth and to the skies above. Since a landowner controls above and beneath his land he can forbid others from flying over it as well as tunneling under it; in the latter case the law governing mining claims is the single exception. Real estate is distinguished from personal property inasmuch as it includes all buildings and fixtures with utensils necessary thereto, such as fences, walls, minerals, furnaces and accessories, gas and water pipes, hat racks and book cases built in the walls or fastened to the floor, keys, blinds, screens, mantle pieces, gas fixtures, etc."

Ownership of Real Estate. Real estate may be owned outright or a person may possess the right to it during his own life or that of another.

An Estate in Fee Simple. An estate in fee simple constitutes an absolute ownership in real estate. This ownership is unconditional and is not hampered by restrictions. We may sell, lease or mortgage such real estate at any time.

An Estate for Life. An estate for life constitutes possession or the right to the use of real estate during one's life or the life of another. It may be limited to an individual to hold for the term of his own life or for that of any other person, or for more lives than one. One who has an estate for the life of another may transmit it to heirs or dispose of it by will until the event happens that terminates the life tenancy.

An Estate in Remainder. If an estate for life comes to an end, the final ownership of the real estate must either be given to another or revert to the original owner or his heirs. If the estate is given to another it is known as an estate in remainder.

An Estate in Reversion. When an estate for life ends and it reverts to the original owner or his heirs, it is known as an estate in reversion.

Obligations of a Holder of an Estate for Life. The holder of an estate for life must make such repairs as are necessary to prevent the property from decaying or depreciating in value. He is not bound to make improvements or to replace buildings destroyed by acts beyond his control, such as fire, flood, cyclone

and other causes, legally known as "Acts of God." If improvements are made, they cannot be in part or whole charged to the reversioner. He need not pay the principal of any incumbrance, such as a mortgage, but he is compelled to pay the interest. He must do nothing to waste the estate, such as opening new mines or cutting all the timber. He may operate mines already open and he may cut a moderate amount of timber. If he should pay the principal of an incumbrance or an indebtedness, he becomes a creditor of the estate and the reversioner must in some manner equitably indemnify the life owner.

Taxes on an Estate for Life. Life owners of real estate must pay the taxes, but in the case of assessments for permanent improvements, such as the building of streets, the laying of sewers and similar benefits in which the reversioner would be benefitted, the reversioner must, of course, pay his portion of such assessments.

INCOME TAX PROCEDURE

Taxes Constitute Deductions from Income. (Income Tax Law, Sec. 214.) "(a) That in computing net income there shall be allowed as deductions:

"(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess profits taxes allowed as a credit under section 222; or (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (e) in the case of a nonresident alien individual, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business.

Assessments not Deductible. (Income Tax Primer, 1919.) "Taxes assessed against an individual on property owned by him to pay for the paving of a street contiguous to his property, the construction of a sewer, sidewalk, etc., or the

construction of ditches to drain property owned by him, can not be claimed as deductions. In short, taxes as are not general in nature and are levied on account of some work or privilege, the benefit of which accrues to a limited number of property owners, of which the taxpayer is one, are not allowable deductions."

Repairs on Real Estate Leased to a Tenant Constitute Business Expenses and are Deductible. (Income Tax Law. Sec. 214.) "(a) That in computing net income there shall be allowed as deductions:

"(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Repairs. (Art. 103. Reg. No. 45, 1918.) "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve."

Repairs on Dwellings Owned and Occupied not Deductible. (Income Tax Law. Sec. 215.) "That in computing net income no deduction shall in any case be allowed in respect of—

"(a) Personal, living, or family expenses;

"(b) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

"(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

A. THEORY QUESTIONS

1. In auditing the accounts of a corporation, for the first year of its existence, what records and documents should be examined in addition to the books of account and the vouchers?
Inst. Ex. 1917.

2. In making an audit, should the auditor require to see the corporate minute book, and such other purely corporate records of a company? Give reasons for your answer.
C. P. A. Ind.

3. What do you understand by the following terms and give illustrations of each: Fixed Assets, Quick Assets, Fixed Liabilities, Current Liabilities, Fixed Charges, Real Accounts, Nominal Accounts, Account Stated, Internal Check?
C. P. A. Mich.

4. A company used its own material and laborers' services in the erection of an addition to its own plant. These additions to Capital account were charged at market prices, the profit on the transaction being absorbed in current trading profits. Do you consider this method correct? Explain fully the principles involved.
C. P. A. Nebr.

5. A concern needs an addition to its plant. Not having enough ready capital, they borrowed money and when the interest was paid it was charged to the "Plant" account on the theory that it was not an expense in the ordinary conduct of the business and should, therefore, not be charged to the regular Interest and Discount account but might with propriety be charged as a part of the cost of the addition. Is the theory sound?
C. P. A. Mich.

6. A company purchased land and on this land was a building which the company had to pull down in order to make the required use of the land. During the demolishing of the building, a workman was killed. To what account should the compensation in respect of this accident be charged and why?
C. P. A. Pa.

B. ACCOUNTING PROBLEMS

1. You are employed to prepare a statement for credit purposes from figures submitted to you in a letter from the Western Manufacturing Company. Their letter submits figures and data as follows:

Their plants stand at cost price, $90,600.00. They have set up a reserve for depreciation of $15,300.00. There is a mortgage of $30,000.00 on the plant and interest on the mortgage is at 6% and is paid to within three months of date of your proposed statement. They hold $15,000.00 of notes receivable and have discounted at bank $37,500.00. Accounts receivable they con-

sider good, amount $27,000.00, including $4,500.00 due from employee on personal account. Accounts with trade customers are subject to 5% discount if paid at due date, and $15,000.00 is now past due. Suspense accounts amount to $6,000.00, 50% of which are believed to be good. A new machine has been ordered but not yet delivered, which cost $9,000.00. They have endorsed a note for $9,000.00 for Smith and Co., but say it will be paid when due. Accounts payable amount to $63,000.00, insurance amounts to $600 a year and has six months to run. They owe a note at bank for $7,500.00, interest paid to date. They own 50 shares of stock in a company from whom they buy raw materials. They cost $4,200.00, and are presumed to be worthless. Inventory was taken at a selling price of 10% more than cost. This amounts to $26,400.00.

You are not asked to accept any responsibility for the figures in the statement but simply to prepare the statement in the best form you can from their letter. C. P. A. Ind.

2. A company is formed under the laws of Mexico, to take over and work certain mining properties. At the end of one year the company is found to possess:

Mining lands	$ 484,675.48
Buildings and Improvements	20,409.76
Machinery	25,612.88
Cash on hand and in bank	24,612.50
Silver Bullion	85,209.50
Ore in dump	13,680.00
Merchandise	5,420.80
Fuel, oil, etc	679.20

The company owes:

On open accounts	3,890.12
On account of pay-rolls	400.00
Note due in six months with int. 6%	25,000.00
Capital Stock (Fully paid) is	500,000.00

Set up Balance Sheet. C. P. A. Mich.

C. INCOME TAX QUESTION

You own two houses, in one of which you live. The other is leased to a tenant at a fixed monthly rental. You paid during 1918 real estate taxes to the state, county, city or township on both properties. You also paid for the repairs on both.

(a) Does the present federal income tax law make any distinction between the two properties as to these two classes of expenses?

(b) If so, explain the reason, if any, for the distinction. Inst. Ex. 1919.

Chapter Nine

FIXED ASSETS (Continued)

Capital and Revenue Expenditures. Buildings are also subject, after construction or purchase, to improvement, betterment, repair, renewal, replacement, alteration, depreciation, assessment, and destruction. All subsequent charges, after the cost has been recorded, raise the question of the proper separation of capital expenditures and revenue expenditures.

Briefly, capital expenditures might be defined as, all sums expended for addition to, or improvement of properties. The American Encyclopedia defines revenue expenditures as, "expenditures made in connection with the running expenses of the legitimate business of the firm or corporation concerned."

Capital expenditures may be charged to the asset accounts affected while revenue expenditures should be charged to the proper expense account. Lawrence R. Dicksee* says, "If an expenditure has only had the effect of putting the earning power of the undertaking upon the same footing as that which had previously obtained, it must be charged to revenue."

In summing up, the auditor should analyze the accounts with fixed assets, and if he finds any items that he is in doubt about they should be noted and carefully investigated. Improvements that increase the earning capacity of the plant and that are not of the nature of either renewals or improvements, may be capitalized. All other expenditures in the nature of upkeep and repairs should be charged to an expense account. Some bookkeepers, when in doubt as to whether an expenditure constitutes an actual improvement, charge it to the asset account anyway. Their reason for so doing is that if it is later found that the item should have been charged to expense, it may be adjusted without much difficulty, while on the other hand, an item charged to expense, but which should have been charged to the asset account, is always difficult to adjust because it is usually necessary to make explanations and secure authority for the adjustment. It is more conservative, however, to overcharge the revenue expenditures than to overcharge the capital expenditures. So far as possible, adjustments should be avoided except when absolutely necessary.

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*Of the firm of Price & Dicksee.

The Theory of the Machinery Account. The object of this account is to show the cost of machinery on hand and in use in the factory. Separate accounts may be kept with different classes of machinery. For instance, one account might be kept with Universal machines and another with Special machines. By Universal machines is meant standard or stock machines that may be purchased from manufacturers whose business it is to manufacture such machines. They are built and carried in stock for sale. By Special machines is meant those specially designed and built either by the concern itself or by another under contract according to specifications. The usual practice, however, is to maintain but one account with Machinery. It is frequently combined with tools, implements, and other items, but this is poor practice and is not to be encouraged.

The account with Machinery should show on the debit side; (a) the cost of machinery on hand at the beginning of the business; (If the machinery is part of a plant that has been purchased or otherwise acquired, for a purchase price covering the entire plant, it may be necessary to estimate the value of each part of the plant subdivided into accounts. Furthermore, the book value set up may not be the actual inventory or appraisal value, but the difference between the asset account and the reserve for depreciation account, applicable thereto, should represent the actual value, provided sufficient reserve for depreciation has been set up.) (b) the cost of machinery and equipment purchased or manufactured by the concern itself after operations have begun; (c) the cost of additions or alterations which actually increase the value and efficiency of the machinery already in use; (This must not be construed to include alterations made necessary by a mere change in product, nor to include the cost of moving and reinstalling machines to permit of more economical operation. In such cases, if the cost is large, it may be advisable to treat it as a deferred expense and to be charged off over a period of years or during the years to be benefited by the changes made.) and (d) the cost of new parts purchased.

With regard to the last item, a great deal will depend on the policy of the firm concerning the method used in arriving at the proper amount of depreciation to be charged off. If the cost of all new parts which are to replace old parts is charged to operating expense, the rate of depreciation will be lower, otherwise, the rate should be higher. If the cost of new parts is charged to the Machinery account, then the cost of the worn parts being replaced should be credited to the Machinery account and at the same time charged to reserve account, because the rate of depreciation charged off to operating expense has been sufficiently high to include the wear of such parts. After a part has been replaced with a new part no further reserve for depreciation on that particular part is necessary, hence it should be charged to the reserve account. Another argument in favor

of charging new parts to the Machinery account is their cost may be higher or lower than the original parts, and if the cost of the old parts being replaced is credited to the account and the new parts charged to the account, the Machinery account will at all times represent the actual cost of machinery in operation.

Any machines or machine parts exchanged, discarded, destroyed, or otherwise disposed of, should be credited to the Machinery account and charged to the reserve account at cost price.

In the case of machinery built or manufactured by the concern itself, the cost should include the cost of material and labor, plus the freight and cartage inward and a proper proportion of overhead expenses. It is customary to add, also, the cost of the experiments, which were made before a desirable type was obtained, plus the cost of the designs and patterns.

The cost of installing new machinery, such as the building of foundations, connecting it with the transmission, moving it into place, etc., is a part of the cost of the machinery and should be charged to the Machinery account. In other words, the Machinery account should show the actual cost of machinery when it is ready for operation.

Montgomery says:

"The cost of installation, including freight, labor, and other items is as much a part of the cost as the price of the machinery itself."

Cox* says:

"The entire cost of installing new machines constitutes an addition and should be capitalized."

Walton says:

"The purchase price, the freight, the cost of moving an old machine to make way for a new one and the cost of installing a new machine are proper charges to the Machinery account."

It is not considered good accounting practice to add interest on borrowed money used to purchase or construct machinery or in the installation process. If this were done the firm who borrowed money with which to construct machinery or to pay the cost of installation, would show the asset at a higher value than the firm who did not need to borrow the money.

The Theory of the Tools and Implements Account. The object of this account is to show the value of small tools on hand. There are several different methods for recording the value of tools. It is always best, if the value of tools on hand is to be considered a fixed asset, to take a physical inventory at the end of the period under audit before preparing the statements. Tools are so often lost, misplaced, or stolen and they are used up so rapidly that it is difficult to determine their actual value in any other manner.

*"Classified C. P. A. Problems and Solutions."

One method is to charge the Tools and Implements account with the cost of all tools purchased and at the end of the year to take a physical inventory and make an adjusting entry crediting the asset account with the cost value of all tools used up or missing and charging the proper operating expense account. If this is done, no reserve for depreciation need be set up.

Another method is to charge the account with tools as above, but to issue all tools to the workmen and at certain times require them to submit all tools for inspection. At this time all tools worn out, broken, or worthless are charged to expense and new tools issued to the workmen. Any tools missing or otherwise unaccounted for are charged to the workmen and deducted from their wages. In either case the account with tools would be credited with the cost price of the tools worn out, broken, worthless, or missing and the balance of the account would show the cost of tools on hand and in use. No reserve for depreciation is necessary, but it is necessary to require the workmen to submit all tools for inspection before preparing the statements. At this time the account would be adjusted.

A third method is to charge all tools and implements to operating expense at the time of their purchase, and if there are any new tools on hand at the end of the fiscal period, their value at cost price is treated as a deferred expense. This method simply necessitates an inventory of new tools on hand undistributed.

Montgomery says:

"As a rule, the practice of depreciating small tools by way of a percentage cannot be followed satisfactorily. So many small tools are used up, or lost, or stolen, that an inventory should be made periodically and all tools on hand revalued. If this plan is followed for several years and a dependable rate of depreciation is secured, it may be feasible to omit the revaluation for a year or two, applying the rate previously ascertained."

The Tax Commissioner of one of the states has adopted rates varying from 25 to 50 per cent, or as an alternative the entire cost of replacements.

Esquerre' says:

"The tools contained in this account are sometimes referred to as 'small equipment.' They comprise, saws, files, hammers, screwdrivers, etc., which on account of their fragility, their size, the manifold uses to which they are placed, and the facility with which they can be passed from hand to hand and from bench to bench, cannot be readily or accurately inventoried. They are generally kept under the custody of a storekeeper and charged to cost of manufacture when issued to the factory."

Greendlinger* says:

"Tools which are fixed and which in reality enter into the same category as machinery, should be valued in the same man-

*Author of "Accountancy Problems with Solutions."

ner. Small tools, however, unless the aggregate is large, should be considered expenses. Where there are a great many it would be better to consider them as supplies and so list them in the inventory."

The Theory of the Account with Horses, Wagons and Harness. This account is rapidly being replaced with accounts with Auto Trucks or motorized delivery equipment. However, the theory of the account is the same. The items charged to it represent delivery equipment. The only difference is the amount of depreciation to be charged off or set up.

Some firms charge the account with the original cost and then charge all replacements and additions to expense. This is hardly to be commended because it does not show true facts at the end of the period. If the original value is increased or decreased by a conservative inventory or appraisement before preparing the statements, the difficulty may be overcome to some extent.

A better practice would be to charge the account with the cost of all delivery equipment and then set up a reserve for depreciation that is estimated to be equal to the reduction in the value of the property. Under this plan, if losses occur by reason of accidents or other causes, the account is credited with the original cost. If the account had been credited direct with the amount of the estimated depreciation, then only the depreciated value would be credited to the account at the time of loss. It is advisable to set up special reserve accounts for each property account subject to depreciation. (Depreciation will be taken up in the Tenth Chapter and will be discussed in detail.)

The Federal Trade Commission, in a bulletin issued July 15, 1916, entitled "A System of Accounts for Retail Merchants,,' says, "Charge the account with Delivery Equipment with the cost of automobiles, wagons, horses, and harness. This account must not be charged with repairs to automobiles and wagons, horseshoeing or anything of this nature. A fair amount should be written off periodically for depreciation."

The Theory of the Office Furniture Account. In practice different methods will be found to exist in recording the value of office furniture or equipment. It will depend upon the policy of the concern. In many instances the account will include fixtures, partitions, etc. What was said with reference to the account with delivery equipment is applicable here. The important thing is to be conservative. If the account is charged with the cost of all office furniture purchased and a reserve account is set up crediting it with the estimated amount of the depreciation each year, it will represent sound accounting practice.

The Federal Trade Commission says in regard to the account with Office Furniture, "Charge this account with office furniture, desks, safe, and other office appliances. It should not be charged with the cost of typewriter supplies, account books, etc., as these are clearly items of expense. A fair amount should be written off periodically for depreciation."

AUDITING THEORY

Quoting from Federal Reserve Bulletin:

Schedules. "In preparing the leading schedules for the accounts grouped under this heading, such as real estate, buildings, plant, machinery, etc., the balances at the beginning of the period, the additions to or deductions from the accounts during the year, and the balances at the end of the period must be shown.

"The total of the balances at the beginning of the period must agree with the cost of property figures given in the Balance Sheet at that date, and the balances at the end of the period with the amount shown in the Balance Sheet that is being audited. The charges entering into the additions must be verified in detail, and in this connection the following notes are of value:

Authorizations for Expenditures. (1) "Authorizations for the expenditures made during the year should be examined, and where the costs of the additions have overrun the sums authorized, inquiries should be made in regard thereto. The authorizations should show the accounts to which the expenditures are chargeable, the amounts thereof, the approvals of the comptroller and manager, and descriptions of the jobs. When the authorizations are not specific as to the work done, the actual additions should, if possible, be inspected.

Additions. (2) "The auditor should satisfy himself before approving additions that they were made with the object of increasing the earning capacity of the plant, and that they are not of the nature of either renewals or improvements, and in this connection changes in the production and capacity of the plant should receive consideration.

Pay Roll and Store and Supply Charges. (3) "To verify the pay roll and store and supply charges to jobs, one or two pay roll distribution reports should be examined in detail, and also one or two storehouse reports. In cases where large purchases have been made from outside parties for capital construction work, the vouchers therefor should be examined and the usual precautions taken to see that they are properly approved for the the receipt of materials, prices, etc.

Real Estate Purchases. (4) "For purchases of real estate the title deeds should be examined, together with the vouchers, and it should be seen that the deeds have been properly recorded.

Factory Overhead Cost. (5) "While it may be considered permissible to make a charge for factory overhead cost to additions to property such as, e. g., time of superintendent and his clerical force employed on construction work, etc., it cannot be deemed conservative business practice, inasmuch as the probabilities are that the overhead charges of a plant will not be decreased to any extent even though additions are not under way, and, therefore, the absorption of part of these charges when additions are in progress, has the effect of reducing the operating costs, as compared with months in which no construction work is under way.

Construction Work in Progress. (6) "Construction work in progress at the end of the fiscal period should be shown in the Balance Sheet under the heading of fixed assets and not as part of the inventories. This is important to bear in mind because construction work is not an asset that can be quickly turned into money, while everything in the inventory is supposed to be realizable in cash within a reasonable short time.

Installments on Construction Work. (7) "The auditor should inquire as to whether any installments are due on account of construction work in progress which is being carried on by outside parties; and if so, the liabilities for these installments should be included in the Balance Sheet, as they may have a direct bearing on the amount of available cash on hand.

Leases. (8) "When a company uses leasehold properties the leases should be examined and notes made of the periods covered, so that it may be seen that improvements, etc., on such properties are written off over the periods covered by the leases.

Reserves for Depreciation. (9) "The auditor should satisfy himself that the reserves for depreciation of buildings, machinery, equipment, etc., are adequate to reflect the deterioration in the value of the fixed properties. If in his opinion the reserves shown on the Balance Sheet are insufficient, he should call attention to the matter in his certificate.

Property Destroyed by Fire. (10) "Care should be taken to insure that property destroyed by fire or otherwise prematurely put out of service is correctly treated in the books. Any portion of the original charge for such property which is not recoverable through insurance, as salvage or otherwise, and has not been provided for by the depreciation scheme should be written off.

"It is to be observed that the foregoing notes are to be applied only to cost of properties incurred during the period

under audit. In addition, information may usually be obtained on broader lines in regard to the composition of the Real Estate, Building, and Machinery accounts, and showing what principal property is represented thereby and how the accounts have been built up from year to year for a reasonable time past if not from the inception of the business. The information derived therefrom is valuable only in indicating the progressive policy of the concern, the extent to which it reinvests undivided surplus in its plan, etc. Beyond these facts the banker who is asked for ordinary discounts or short-term loans is not interested; he looks more to the quick assets for his security.

When an Appraisement is Necessary. "Optional.—When the loan is greater than the quick assets seem to justify the auditor should suggest a reliable verification of the cost of property prior to the period under audit. Such action may become necessary even to the extent of calling for an appraisement by disinterested outside experts."

AUDITING PROCEDURE

Analyzing Fixed Assets. J. I. King, junior accountant, made an analysis of the fixed asset accounts. Inasmuch as all account footings had been carefully verified when the Trial Balance was vouched, it was only necessary to determine whether all charges to the asset accounts represented actual capital disbursements and that adequate reserves for depreciation had been set up.

The Land Account. The amount charged to this account, $100,000.00, represents the actual cost of the land at the time of its purchase. The deed was examined and found to be properly recorded.

The Buildings Account. Building operations were begun immediately after the purchase of the land and the book value as set up represents the actual contract price of the buildings when completed. A reserve for depreciation amounting to 2½% has been set up annually. The Buildings account shows a debit of $150,000.00, and the Reserve for Depreciation on Buildings account shows a credit of $2,500.00. The buildings were completed May 1, 1917, and the Reserve, at the end of the year, was credited for depreciation on the basis of ⅔ of a year.

A question might arise as to whether this represents a proper percentage of depreciation. Inasmuch as the buildings are of concrete and brick construction, it is considered adequate. (See discussion of Depreciation, Chapter Ten.)

The Machinery Account. The book value amounting to $100,000.00 represents the original cost price of all machinery, including installation. An item amounting to $215.00 was found to have been posted to Tools and Implements, but it should have been charged to the Machinery account, as it represented the cost of a new machine. A reserve for depreciation amounting to 6% has been set up annually.

After the Machinery account was adjusted it showed a debit footing of $100,215.00. The Reserve for Depreciation of Machinery account shows a credit of $9,000.00. The original Machinery was purchased July 1, 1916. A new machine costing $215.00 was purchased July 1, 1918.

Tools and Implements Account. This account shows a debit balance of $20,215.00. $215.00 charged to this account represents an addition to machinery and was posted to this account through an error. It was adjusted. No reserve for depreciation account was set up. The practice has been to credit the account direct with the amount of the estimated depreciation which was arrived at after a physical inventory. On December 31, 1918, a physical inventory was taken under the supervision of the different foremen. Further investigation shows that the balance of the account represents the actual cost value of all tools considered new or unworn at that date and either in the hands of the workmen or undistributed. On December 10, 1918, there had been purchased $5,250.00 worth of new tools that had not yet been distributed. The amount, at cost price, of tools used up during the year had been charged to operating expense.

Horses, Wagons and Harness Account. The balance of this account shows a debit of $15,000.00. The practice has been to charge the cost of horses, wagons, and harness purchased to the account. The account is credited with the cost price of any items sold, exchanged, destroyed or discarded. The Reserve for Depreciation account shows a balance on the credit side of $1,500.00. This account is credited annually with 10% of the cost as shown by the account at the beginning of the year. The equipment was purchased January 1, 1917, and no additions have been made since that time.

Office Furniture Account. This account was found to show a debit balance of $2,600.50. No reserve for depreciation has been set up, the practice being to credit the account annually with the estimated amount of depreciation. The depreciation has been calculated at 10%.

Book Variations. Montgomery says: "Where an auditor cannot secure reliable information with respect to plant valuations

he should state in his report that real estate, machinery, and similar assets are stated at book valuations. He should, however, attempt to ascertain whether these book valuations honestly reflect present conditions. His services are of little real value if such items are grossly overvalued and a net worth is shown which should be corrected by an intelligent use of evidence easily available by the auditor.

"The auditor is charged with the duty of attempting to analyze the fixed assets as shown by the books to ascertain the principles upon which they have been created."

THE LAW OF PERSONAL PROPERTY

It is appropriate that we discuss the law in its relation to property at the same time we discuss fixed assets. Fixed assets, as has already been made clear, are to be classed among the real accounts. There is a distinction, however, between real accounts and real property. Real property has already been defined in the preceding chapter. Real property, including land, buildings, etc., is a fixed asset unless it represents the stock-in-trade of the concern. Naturally, if one's business is that of a dealer in real estate, such real estate becomes a current asset the same as any other stock-in-trade.

Personal property, however, may represent either a current or a fixed asset, for it includes both the stock-in-trade and all equipment which cannot be classed as real property. It will be seen from the above distinction that it is important that the accountant be able to distinguish between real and personal property. We can do no better than to quote from Peters' Commercial Law* with regard to the kinds of property.

"Personal property is movable in its nature, and includes every particular sort of property not possessing the nature of real property, such as promissory notes, merchandise, crops, furniture, mortgages, books, stocks and bonds, animals, patents, manufactured goods, and the like. Personal property may be changed into real property, as where one takes brick and mortar—all personal property— and constructs a house with them which is then considered real property; and if in the lapse of time that same house be razed to the ground and the building material sold as such they again acquire the characteristics of personal property.

Chattels. "The name 'chattel' is frequently applied to personal property and is the term usually employed at the common law to denote personal property in general. It is a more extensive term than goods or effects and includes every kind of property except property in land. Its meaning is com-

*By P. B. S. Peters, LL. B. Published by South-Western Publishing Company.

monly confined to things movable in their character, as animals, machinery, grain, or any article that can be handled and transported.

Ways of Acquiring Title to Personal Property. "The two general ways in which title to personal property may be obtained are: (1) by original acquisition; (2) by transfer.

(1) **Acquisition.** "Under original acquisition the first general method of acquiring title is by occupancy. This is brought about by taking into one's possession what previously belonged to no other person, or what was abandoned by a prior owner.

"Wild animals belong to no one in particular until they are captured. Whoever captures such an animal has the exclusive right to it while in his possession, or until it has become so far domesticated that it has the habit of returning after wandering at large. If, however, it escapes and regains its natural freedom any other person may rightfully take it who captures or kills it. A mere temporary escape, as where a lion escapes from its cage, may not amount to regaining its natural liberty.

"The finder acquires title to personal property abandoned by the owner of property that has been lost but never reclaimed. But the former owner must have completely relinquished his ownership intending to give up all his rights in it before a perfect title will accrue to the finder.

Accession. "Title by accession is defined as the right to all which one's own property produces, either naturally or artificially. This includes the crops yielded by land; the increase of animals; the uniting of the property of one with the property of another, as when an artist paints a picture on the canvas of another, the whole belongs to the artist, but the other has a claim for the value of the materials. Also by the mixing or confusion of goods, which occurs when one person wilfully mingles his own goods with another that they cannot be distinguished from each other. If the mixing was by consent, each has a pro rata interest in the entire mass.

Intellectual Labor. "Authors, composers, and inventors have the exclusive use and control for a limited time in such personal property as owes its existence or value to their skill and labor. The general doctrine is that one has a proprietary right in the product of his intellectual labor and that this right should be protected by law for the purpose of promoting science, encouraging literature, and stimulating inventions.

"A copyright is a grant to authors of the exclusive right to possess, use and dispose of their intellectual productions.

This gives the owner the right of making, publishing, and selling, or authorizing others to do so for a period of twenty-eight years, with the privilege of a renewal and extension for a further term of twenty-eight years.

"A copyright may be secured for books, periodicals, lectures, sermons, addresses, dramatic and musical compositions, maps, works and reproductions of works of art, drawings, photographs, prints, pictorial illustrations, motion pictures, etc.

"A patent is a grant for the exclusive privilege of making, using, and vending, and authorizing others to make, use and vend an invention for a period of seventeen years. The invention must be a new and useful art, machine, or composition of matter, not before known and used.

Transfer of Property. "Title to personal property may be acquired by transfer in two general ways: (1) by act of law; (2) by act of the parties.

"Transfer of title to personal property by act of law occurs (a) by forfeiture, (b) judgment, (c) intestacy, and (d) insolvency.

"(1) Forfeiture is a loss of title by the owner as a punishment for a crime, a penalty for the violation of law, or a breach of contract. Title by forfeiture is practically obsolete at the present time as a punishment for crime. However, there may be a forfeiture of goods for the evasion of revenue laws, or of shares in a corporation for a failure to pay assessments when due.

"(2) A judgment is a decision or sentence of law pronounced by a court or other competent tribunal having authority as the result of proceedings instituted for the redress of an injury or the settlement of a controversy. Title to personal property occurs as a result of a decree entered in an action whereby a person becomes entitled to take property belonging to another.

"(3) Intestacy is the state or condition of a person dying without having made a will, leaving personal property undisposed of. The title is vested in the administrator as a trustee for the purpose of settling the estate, and the property is distributed in accordance with the statute laws of the state where the deceased person resided.

"(4) A bankrupt's property is transferred by operation of law to an assignee or trustee who has authority to administer the same for the benefit of the creditors.

"Transfer of title to personal property by act of the parties occurs in a contract of sale which is a transfer of the property in a thing for a money consideration called a price. The transfer may be by an exchange of property, whereby the title in property passes to another in consideration of the receipt by him of other property. Again, it may be in the form of a gift which is the actual, voluntary, and gratuitous transfer of property from one person to another. The gift must be accepted by the person to whom made, but the acceptance is presumed. Then again, the transfer may be in the form of a written instrument designated a will which provides for the disposition of property to take effect after the death of the person who made the will."

A. THEORY QUESTIONS

1. Mention under what circumstances, if any, reconstruction or rehabilitation expenses of a street railway company may properly be charged to property accounts. C. P. A. Ind.

2. An alteration to existing equipment is made in a factory. State what you would do with the cost of such alteration. C. P. A. Ind.

3. Auditing the yearly results of a large engineering company you find that the machinery and tools, which had been regularly depreciated for a number of years, have, during the year under audit, been appraised by a reputable appraising company, and have been revalued at a larger sum than the debit balances in the books. How would you dispose of the increased value due to the appraisal? C. P. A. Ind.

4. A company purchased several machines and, in order to install them to the best advantage, old machines which are to remain in use were moved to make room for them. The machines were large and had to be taken apart before they could be moved. To what account would the cost of moving be charged and why? C. P. A. Pa.

5. You receive the following letter:

"We have never had our books audited but are contemplating an audit now. Two of our friends have recommended you to us. Both have businesses similar to ours but their advices as to the time required are very different. Do you carry out different kinds of audits? If so, what are the different kinds and under what circumstances do you recommend one kind and when another?"

Write reply. Inst. Ex. 1917.

B. ACCOUNTING PROBLEMS

1. In the machinery account of a company under audit, you find the following among other items:

Dr.		Cr.	
Purchase of two machines, type A, including freight	$8,000.00	Sale of old machine, type A (less cost of removal and freight)	$1,264.00.
Cost of removing a disused machine, type B, to make room for new machine	160.00	Sale of old machine, type B	1,470.00.
Cost of installation of two new machines	280.00		
Alterations to four type C machines, necessitated by change in product	640.00		
Cost of moving two machines from building A to building B to permit of more economical operation, including reinstallation	270.00		

The balance on Machinery Depreciation account shows an increase for the year of the amount provided out of income, which is computed at the rate of 4% on the balance of Machinery account at the commencement of the year. The method of keeping the Machinery and Machinery Depreciation accounts has been in force from the commencement of operations. Draft your comments as auditor of these accounts, assuming that no items other than those above mentioned call for any comments. Inst. Ex. 1918.

2. You are called upon to audit the books of a partnership which has been in existence for one year. You find that A's Balance Sheet, prepared just before B was admitted as a partner, shows the following accounts:

Cash in the bank, $500.00; real estate, $20,000.00; machinery, after 10 per cent depreciation, $40,000.00; accounts receivable, $7,542.50; stock on hand finished, $10,000.00; stock in process of construction, $1,000.00; raw material, $957.50; bills payable, $20,000.00; accounts payable, $30,000.00.

After examining the copartnership agreement, you find that A agreed with B to sell him one-half interest in the business for the sum of $20,000.00 to be contributed to the new firm, the new firm to take the assets of A with the exception of the real estate and assume the liabilities, and that the good will of the business of A should be rated at $20,000.00 in the new firm's books.

During the course of your audit you discovered the following discrepancies:

(a) The inventory of finished stock was incorrect. The value should have been entered at $8,000.00 instead of $10,000.00.

(b) Of the accounts receivable, $6,500.00 were collectible. One of the debtors owing $500.00 failed, leaving no assets, previous to the formation of the copartnership, which fact was known to A but his bookkeeper, who had been instructed to charge off the account had failed to do so. $1,000.00 of the accounts receivable represents accounts ascertained to be worthless since the copartnership was formed.

The Trial Balance at the end of the year's business showed as follows:

A Capital Account		$ 25,000.00
B Capital Account		25,000.00
Merchandise		75,000.00
Accounts Payable		40,000.00
Accounts Receivable	$10,000.00	
Machinery	40,000.00	
Factory Wages	35,000.00	
Non-productive Labor	5,000.00	
General Factory Expense	20,000.00	
Rent	1,500.00	
A Personal Account	2,500.00	
B Personal Account	2,500.00	
General Expense	2,000.00	
Good Will	20,000.00	
Cash	26,000.00	
Profit and Loss	500.00	
	$165,000.00	$165,000.00

Inventories at close of year:

Stock on hand finished	$25,000.00
Stock in process of construction	2,500.00
Raw Material	2,500.00
Total	30,000.00

No correction was made of the discrepancies and no amount has been charged off for depreciation of machinery, which should be 10 per cent.

Make proper entries to correct books with reasons for such entries in full, also formulate Balance Sheet showing the standing of the firm after the books were closed. C. P. A. Mich.

(**Note.** In connection with the second Accounting Problem, there are several legal principles involved. You may assume that B accepted the Assets and Liabilities of A as stated on A's books with the exception of the Account Receivable amounting to $500.00 known to be worthless by A, but which was included in his assets through an error on the part of the bookkeeper.

The overvaluation of the inventory probably was unknown to both A and B until the auditor ascertained this fact. The accounts proved to be uncollectible, excepting the account mentioned above, could not be foretold, and were accepted by A without a reserve for such a loss, therefore, you may assume that these two items are losses of the partnership to be borne equally by A and B.

As a result of this information, two correcting and two adjusting entries are necessary. These should be set up in journal form and posted to the accounts, after which a Trial Balance should be taken and a Balance Sheet made.)

C. LEGAL QUESTIONS.

1. Name the two divisions of property and explain each.

2. Define personal property.

3. What is chattel property?

4. When are trees real property and when are they personal property?

5. (a) Name four methods by which title to personal property may be transferred by acts of law.

(b) May personal property be transferred by acts of the parties? If so, explain how.

Chapter Ten

DEPRECIATION

Depreciation Defined. Depreciation is the shrinkage in value of an asset due to deterioration through wear and tear caused by use or by a mere lapse of time, accidents, inadequacy, or obsolescence. The importance of its being considered from an accounting standpoint can hardly be overestimated. Without a doubt, failure to provide for the depreciation of the fixed assets, has contributed to the failure of many concerns in the past.

In a decision by the New York Court of Appeals, the following statement appears:

"Judicial notice may be taken of the fact that in the conduct of many industrial enterprises there is a constant deterioration of the plant which is not made good by ordinary repairs and which, of course, operates continually to lessen the value of the tangible property which it affects. The amount of this depreciation differs in different enterprises, but the annual rate is usually capable of estimate and proof by skilled witnesses. No corporation would be regarded as well conducted which did not make some provision for the necessity of ultimately replacing the property thus suffering deterioration; and we cannot see why an allowance for this purpose should not be made out of the gross earnings in order to ascertain the true earning capacity."

A few years ago an underwriting syndicate undertook the reorganizing of the Rock Island Companies. Its plans were to issue 7 per cent preferred stock on the basis of an 8 per cent income. To the dismay of the members of the syndicate, the Interstate Commerce Commission ruled that all the railroads under its control must include, as a charge against their profits, a satisfactory percentage of the railroad equipment, such percentage being the estimated amount of depreciation of the property. As a result of this ruling the net income of the Rock Island Companies fell to 3½ per cent. This rate of income was insufficient to warrant the issue of 7 per cent stock and the syndicate collapsed. The practice of most of the railroad companies had been to disregard the theory of depreciation. They simply discarded old equipment made worthless through wear and tear and borrowed money to buy new equipment. It dosen't require much wisdom to see the folly of such a plan and the ultimate results are quite clear. A firm that divides all its net income without providing for depreciation on its fixed assets is simply "robbing Peter to pay Paul" and it reminds one of the story of the two men, shipwrecked on a deserted island, who during the time they were stranded became rich trading knives with each other.

Causes of Depreciation. There are four principal causes of depreciation. These have been so ably and clearly described by Professor M. E. Cooley that we will quote him in detail:

"1. Depreciation Due to Wear and Tear and Exposure to the Elements. This is continuous. All elements have a wearing life varying with the element itself. No element can be completely worn out; it can be worn only to a point below which it becomes unsafe or no longer serves its original function. In practice, the average condition of all elements must be maintained at a high percentage of the original cost if the property is to serve its purpose properly. This percentage varies from 75 per cent to 85 per cent of the cost of the property. The difference between this percentage of from 75 to 85 and the original 100 is a depreciation which is inherent in the property and cannot be dispensed with. It must be met by a sinking fund, or its equivalent, otherwise this part of the original investment is lost.

"2. Depreciation Due to Accidents; Sudden Depreciation. An engine or a boiler may be wrecked, and with it, other machinery. This might, and probably would, involve a considerable expense for repairs or replacements besides possibly crippling the plant in part. Cars may collide or a car may drop through a bridge. A bridge itself may fall or be carried away by flood. A storm or a cyclone, may work havoc, entailing costs in excess of those proper to be charged to ordinary maintenance of property.

"3. Depreciation Due to Inadequacy. Cars suitable in the past had already been superceded several times by larger and better cars. This has rendered the track, structure, and bridges inadequate, and as more power is required to propel the larger cars, the power plants have become inadequate. The public demand is largely responsible for this depreciation due to inadequacy.

"4. Depreciation Due to Obsolescence. This, while closely allied to the depreciation due to inadequacy, is different in that it embraces changes due to advance in the art. More efficient and effective machinery has appeared which must be substituted for the old to keep abreast of the times. For example, in steam-engine practice the turbine has come into geneıal use during the past five years and the art of steam turbines is at the beginning. Generators adapted to piston-engine practice are not adapted to steam-turbine practice and must be changed. Boilers adapted to piston-engine practice must be replaced to carry the higher pressures required. Condensers must also be changed to secure the better vacuum required to realize the full advantage of the steam turbine. Owing to the rapid disappearance of coal beds, the price of fuel must advance. and this presumably will, before many years, force the adoption of the gas producer and the producer gas engine. Water powers are wisely being developed, but to utilize them requires the scrapping of large parts of the machinery in use at present."

In regulating depreciation in respect to income taxes, deduction is allowed only for loss due to wear and tear of property used in the trade or business. This does not include provision for obsolescence since it is provided that when an asset is actually determined to be obsolete the loss may be deducted at that time. However, obsolescence should usually be provided for periodically as well as depreciation from wear and tear, as the government's permission to make eventual deduction for loss from obsolescence does not justify a waiver of the fundamental accounting rule to provide for all possible losses.

Factors Bearing on Amount of Depreciation. In determining the probable amount of depreciation on any fixed asset there are certain factors to be taken into consideration such as original or prime cost, probable life of the asset, repairs and replacements, residual or scrap value and the possibility of obsolescence.

1. The original or prime cost is the basis of all calculations. It should include all the elements of cost such as freight and cartage inward, cost of installation, etc.

2. The probable life of the asset, or the number of years it is estimated to be of use, is the next factor to be considered. This varies so extensively, even with the same kinds of machines, or other assets, that it is always a difficult item to arrive at with any degree of accuracy. About the only way of determining the life of an asset is by experience.

Earl A. Saliers, author of "Principles of Depreciation", says:

"But efficiency, the test of present usefulness, is not the only factor that determines value. Value depends upon the length of time over which such usefulness will continue. Two similar machines may be equally efficient today; but one may continue to be useful for two years and the other for four. Can we say that they have equal value? There may be some uncertainty in individual cases; but the uncertainty is limited within certain bounds, and to a great degree vanishes when averages are considered, just as the uncertainties of lifetime vanish when large numbers of lives are considered. The lifetime of a single freight car is very uncertain but the average lifetime of a thousand cars is ascertainable to the fraction of a year."

3. Repairs and replacements of property affect the rate of depreciation, consequently, the auditor should not decide on the amount required for depreciation until he has scrutinized the Repairs and Maintenance account. He may find items charged to this account that should have been charged to the Reserve for Depreciation account because they represent expenditures that decrease the deterioration and should have the effect of reducing the depreciation charge.

The usual procedure in practice is to charge all items representing repairs and replacements to either expense or to the Reserve for Depreciation account. In deciding which account should be charged it is necessary to determine whether the

expenditure is one provided for through cumulative depreciation allowances. Ordinarily small incidental items of repair, replacement and maintenance are charged to expense and larger items of renewal and replacement are charged to the depreciation reserve. Remember, that with either plan it is a deduction from income, but the point in question is, that the expenditure must not be charged to expense, and at the same time, another charge be made on account of depreciation. (See page 154 for Income Tax Procedure).

Like nearly all rules, there is an exception here in connection with old, run-down or partially worn-out assets purchased with the intention of remodeling, rebuilding or rehabilitating them so they can be operated efficiently again. In such cases, it is permissible to charge all repairs and renewals to the asset accounts affected, thereby capitalizing such expenditures.

4. The total amount of depreciation of an asset will be the difference between its original cost and its residual or scrap value when it ceases to be useful and must be discarded. Whatever can be realized from the sale of an asset at the time it is discarded reduces the loss and thereby the amount of depreciation.

5. Some assets are quite likely to become obsolete even before they have become useless through wear and tear. The possibility of obsolescence, therefore, is a matter for consideration.

Methods Used for Calculating the Depreciation. There are several methods advocated for calculating the proper amount or rather the annual rate of depreciation. We shall discuss briefly the principal methods used.

1. Straight Line Method. In this method the life of the asset is estimated and the cost of such asset less its scrap or residual value is written off over such estimated life. The amount of depreciation for each year is found by dividing the difference between the cost and residual value by the number of years of the estimated life of the asset.

To illustrate, let us assume that the cost of a certain machine is $81.00, its estimated life is four years, and its residual or scrap value is $16.00.

By deducting the scrap value, $16.00, from the cost, $81.00, we get $65.00, the amount the machine is expected to depreciate in four years, its estimated life. $65.00 divided by the number of years, four, shows $16.25, the annual amount of depreciation to be charged off. The amount of annual depreciation, $16.25 divided by the cost, $81.00, shows the rate of depreciation to be 20 5/81%.

This is the simplest method for calculating depreciation and consequently is very popular. It is the method in general use, and is acceptable to the Interstate Commerce Commission and the Internal Revenue Department. The method has been criticized by some accountants and others for various reasons.

Saliers says in this connection:

"It is free from interest complications, and its employment does not require a knowledge of the logarithmic or any other method of finding roots and powers of numbers. Speaking generally, there appears to be no reason why the straight line method does not approximate actual depreciation as nearly as any of the complicated curves at times advocated, apparently on the assumption that actual depreciation finds a counterpart in the accuracy of their mathematical computations."

2. Diminishing Value Method. In this method it is customary to estimate a minimum life of the asset and then depreciate the residual value each year. That is, instead of basing the annual depreciation during the life of the asset on the original cost, as in the straight line method, it is based on the value of the asset at the beginning of that period after having deducted the total amount of previous depreciation. A percentage rate is ascertained which, when applied each year to the balance remaining after the similar deduction for the preceding year, will reduce the balance to the scrap value at the end of life of the asset.

Using the same problem as shown under the straight line method, it will be seen that it requires a rate of 33⅓% to reduce the asset to a scrap value of $16.00 in four years. Note the following calculations:

Original cost of machine	$81.00
Less Depr. (33⅓% of $81.00)	27.00
Value beginning of second year	54.00
Less Depr. (33⅓% of $54.00)	18.00
Value beginning of third year	36.00
Less Depr. (33⅓% of $36.00)	12.00
Value beginning of fourth year	24.00
Less Depr. (33⅓% of $24.00)	8.00
Residual or scrap value	$16.00

It will be seen that the amount of depreciation is greater at the beginning but decreases with the life of the asset. It is held by some that this is reasonable because the cost of repairs and maintenance is least while the asset is new but increases as the asset is used. Therefore, the total depreciation and upkeep will be nearly uniform each year. On the other hand, the concern is forced to charge off a larger amount of depreciation at the beginning of its existence when profits may be small. Another objection is the fact that it involves a complicated mathematical calculation, and the annual rate of depreciation gives little indication to the ordinary man of the period required to write off the asset.

3. Annuity Method. In this method the plan is to estimate an amount which, if annually set aside at interest, would at the end of the life of the asset amount to the difference between cost and scrap values. A sum is determined which, when set

aside each year at compound interest, will accumulate, during the life of the asset, and will just equal the scrap value at the end of its estimated life.

Hatfield, in his Modern Accounting, says:

"It rests upon the assumption that the cost of production includes not only repairs and the depreciation of machinery, but as well, interest on the amount of capital invested in the asset. Depreciation on this theory should be a sum figured as a constant annual charge sufficient not only to write off the decline in value, but also to write off annual interest charges on its diminishing value."

Using the same problem as above, it will be seen that the annual amount of depreciation is equivalent to a rate of 27 47/162% based on the original cost. Note the following calculations:

Original cost of machine	$81.00
Interest at 10%	8.10
	89.10
Depreciation first year (27 47/162%)	22.10
Value beginning of second year	67.00
Interest at 10%	6.70
	73.70
Depreciation second year (27 47/162%)	22.11
Value beginning of third year	51.59
Interest at 10%	5.16
	56.75
Depreciation third year (27 47/162%)	22.10
Value beginning of fourth year	34.65
Interest at 10%	3.46
	38.11
Depreciation fourth year (27 47/162%)	22.11
Residual or scrap value	$16.00

(Interest at the rate of 10 per cent was used for convenience in arithmetical calculations.)

This method is objectionable because of the inclusion of interest on invested capital. Of course, the writing up of the asset is offset by the increased depreciation. The method is inconsistent unless interest is charged on all the capital invested.

4. Production Unit Method. In this method the estimated life of an asset is based on its production. The plan is to charge off an established rate per unit of output. It may be applied

to such assets as diminish in value in exact ratio to the amount used. For instance, if the machine mentioned above was designed to produce 1,000,000 units at a total cost of $1,000.00, the depreciation charge would be 1 mill per unit of production.

Comparison of Methods for Calculating Depreciation. Walton says with regard to the significance of each method:

"(a) The Straight Line Method distributes the burden of depreciation equally over all the years, without regard to the constantly increasing repairs.

"(b) The Diminishing Value Method starts with a heavier burden of depreciation which gradually diminishes, the theory being that as the repairs increase on account of the increasing deterioration of the asset, the decreased depreciation tends to equalize the burden over the years. It also provides for a residual or scrap value, as the carrying value never reaches zero.

"(c) The Annuity Method takes into consideration not only the cost of the asset, but also the interest on the diminishing value. As the credit to interest diminishes each year and the charge for depreciation remains constant, the net expense increases annually. In addition, few accountants are in favor of considering interest on the cost of fixed assets as an operating expense."

Dicksee, a prominent authority, favors the first method for short-lived assets, the second for machinery in general, and the third for long-time terminable leaseholds and similar assets. Where courts have prescribed depreciation, they have generally allowed the basis of calculation to be left to the discretion of the company. This is also true with the Internal Revenue Department. The Interstate Commerce Commission prescribes the first method for figuring depreciation. It is compulsory with concerns coming under the Commission's Control.

Accounting Procedure with Regard to Depreciation. Either a reserve for depreciation or a reserve fund may be created, or the asset account may be credited direct for the amount of the depreciation.

(a) Writing Down the Asset. If the amount is credited direct to the asset account, it is known as writing down the asset. The principal objection to this plan is that the original cost of the asset is lost sight of. From an accounting standpoint, the asset accounts should show costs of assets on hand at the date of the Balance Sheet. If the depreciation is credited direct to the accounts with assets, this policy is interfered with making it necessary to analyze the accounts in order to ascertain the cost of assets.

(b) General Reserve for Depreciation. Some firms create a general reserve for depreciation. This is considered poor accounting for the reason that the account includes the depreciation on all classes of assets and it is impossible to ascertain

the net carrying value of any particular asset or class of assets without first analyzing the account. It is also difficult, if not impossible, to verify its accuracy as time shows how much the actual depreciation on a special class of assets has been. It will be seen, therefore, that the same objections may be made to either of these plans.

(c) Specific Reserve for Depreciation. Without a doubt this is the best plan of all. The amount of depreciation is credited to a reserve for depreciation on each asset affected. This reserve is then deducted from the asset to which it applies in the Balance Sheet so that the asset is shown at its cost, less depreciation, and its present value shown as a current or fixed asset. This is the net carrying value to the business.

(d) Reserve Funds. In all the above methods the effect of the provision for depreciation is simply to provide for depreciation and deterioration by setting aside a part of the profits annually and preventing their distribution. However, creating the reserve does not set apart a specific sum and label it for the purpose of replacing certain assets. Creating a reserve fund is entirely different from creating a reserve for depreciation. The object of the reserve fund is to set aside annually a certain sum estimated to be sufficient to replace a certain asset when it has become worthless or obsolete. In the first three methods outlined above, the problem of interest does not arise. When a reserve fund is created and a certain sum set aside and invested in securities, these securities will earn interest which in itself may increase the fund or may be treated as an income on the books and not a part of the fund. While this plan has its advantages, at the same time it reduces the working capital of the company by tying up a certain part of its funds in such a manner that they cannot be used for any other purpose than that for which they were intended. By the reserve for depreciation methods, that part of the profits set aside, are retained in the business as working capital and may be reinvested in stock-in-trade or other assets, the income from which will very likely be greater than could be realized from a reserve fund invested in conservative securities.

In order to illustrate the four methods explained above, let us assume that the depreciation on a certain machine costing $1000.00 amounted to 10 per cent the first year, or $100.00. Under the first plan a journal entry would be made as follows:

Manufacturing Expense............	$100.00	
Machinery...................		$100.00

Note that the Machinery account is credited for the amount of the depreciation thus reducing its value on the books.

Under the second plan the following entry would be made:

Manufacturing Expense............	$100.00	
Reserve for Depreciation.......		$100.00

A general Reserve for Depreciation account is here credited. The same account would also be credited for the amount of

depreciation on buildings, furniture, delivery equipment and possibly even for a reserve for doubtful accounts. The asset account with Machinery is not affected by the entry.

Under the third plan the following entry would be made:

Manufacturing Expense............$100.00
Reserve for Depr. on Machinery. $100.00

A special Reserve for Depreciation on Machinery account is credited. The asset account with machinery is not affected. In stating the value of machinery in the Balance Sheet, the reserve for depreciation on machinery is deducted and only the net amount listed as an asset.

Under the last plan two entries are necessary, the first setting up the depreciation and the second establishing the reserve fund.

(First Entry)

Manufacturing Expense............$100.00
Reserve for Depr. of Machinery. $100.00

(Second Entry)

Reserve Fund.....................$100.00
Cash......................... $100.00

It will be seen that the first entry is the same as that under the third plan above. The second entry is entirely different and is really no part of the depreciation entry. After this last entry has been made the cash would be turned over to a trustee, much the same as in the case of a sinking fund, and he would be instructed as to the handling of the fund. It is usually invested in high-grade securities.

Appreciation. It is always unwise to write up the value of assets even when they have undoubtedly increased in value. If we are to stick to the rule that no profit can be made except through sales, then we can never, under any circumstances, show appreciation of assets by increasing their book value.

Sometimes it is held that the appreciation offsets the depreciation and that no provision for depreciation need be made. For instance, the increase in the market value of agricultural land, might be such that it would seem that no depreciation should be considered. The fact is that the present increase in market value is a mere fluctuation in prices and may suddenly decrease while the productive value would not in the least be affected by such fluctuation. Experience has shown clearly that agricultural land is depreciating in productive value through its use. At present the upkeep is not such as to maintain the original productive value of such land and therefore, it is advisable to provide for certain depreciation.

Under no circumstances should an estimated appreciation of one asset be considered to have offset the depreciation of the same or another asset.

INCOME TAX PROCEDURE

Depreciation is a Proper Deduction from Income. It has been shown that depreciation is an operating expense and that it should be charged off by writing down the value of the fixed assets or by setting up a reserve for depreciation, preferably the latter. The Income Tax Law has clearly recognized this theory.

Income Tax Law. Section 214 (a-8) [Individuals]; Section 234 (a-7) [Corporations]. "In computing net income there shall be allowed as deductions:

"A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business."

Capital Expenditures not Deductible. Expenditures which actually increase the value of the assets cannot be deducted as an expense.

Income Tax Law. Section 215 for individuals and Section 235 for corporations. "That in computing net income no deduction shall in any case be allowed in respect of—

"Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

Replacements and Renewals must not be Deducted Twice. As previously explained expenditures for repairs and replacements cannot be deducted as an expense and again be provided for through a depreciation reserve.

Income Tax Law. Section 214. (c) "That in computing net income no deduction shall in any case be allowed in respect of—

"Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

(Reg. No. 33, 1918, ¶ 432.) "The cost of incidental repairs which neither add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided that the plant or property account is not increased by the amount of such expenditures. Such repairs, to the extent that they arrest deterioration, should have the effect to reduce the depreciation charge otherwise deductible."

Income Tax Primer, 1918, question 99. Ruling. "If a tax payer wishes to claim the full amount of depreciation estimated to have occurred in the value of a building or other property used for business or trade purposes, he may do so, but this precludes his claiming a deduction to cover any amount expended during the same year in making repairs. If he wishes to claim a deduction on account of repairs, their cost must be deducted from the full amount of depreciation, and the balance

may then be claimed as a deduction under the heading of 'Depreciation'; that is, if the tax payer expends $100.00 in making repairs to a building which will depreciate in value $200.00 during the calendar year he may claim $100.00 as a business expense and $100.00 as depreciation, or he may claim $200.00 as depreciation and nothing for repairs, in short, the aggregate deductions claimed on account of repairs and depreciation must not exceed the full amount of depreciation estimated to have occurred. (Note—The repairs referred to in this paragraph are such as are general in character, represent replacements, etc. Small items, such as replacement of broken window panes, papering, minor repairs, etc., are allowable, even though full amount of depreciation has been claimed.)"

Depreciation must be Entered on the Books or it Will not be Deductible. The 1918 law does not specify that depreciation must be charged off on the books of an individual or a corporation, but the commissioner is given ample power to enforce proper accounting methods and the following regulations show that he has done so.

(Reg. No. 33, 1918, ¶ 484.) "Within the purview of this item depreciation, to an amount measuring the decline in value due to exhaustion, wear and tear of property arising out of its use, is a loss. This loss, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which the amount shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or credited to a Depreciation Reserve account, and as such shall be reflected in the annual Balance Sheet."

(Reg. No. 33, 1918, ¶ 480.) "The fact that no reserve was made for depreciation indicates that there is no loss on this account to be provided for."

Basis of Depreciation. (T. D. 2754, Aug. 23, 1918.) "A reasonable allowance for the wear and tear of property arising out of its use or employment in the business or trade is to be based on the cost of such property or on its fair market price or value as of March 1, 1913, if acquired prior thereto. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property, less depreciation up to that date."

Rates of Depreciation. (Reg. No. 33, 1918, ¶ 485.) "No definite rate has been fixed by which an allowable deduction on account of depreciation in the value of any class of property subject to wear and tear is to be computed, but it is contemplated that this allowance shall be computed upon the basis of the cost of the property and the probable number of years constituting its life. The deduction to be allowed relates solely to loss due to use, wear and tear, and the matter of ob-

solescence is not relevant, inasmuch as when the property becomes obsolete a deduction for the loss sustained thereby, representing the difference between the cost and the amount of depreciation previously charged off or which should have been charged off in prior years will be allowed."

It will therefore, be noted that the law makes no reference to definite rates of depreciation. Neither does the Treasury Department specify rates which shall be considered satisfactory. The law merely specifies that the depreciation allowances shall be "reasonable."

REVIEW OF THE LAW OF CONTRACTS

As to time of performance, contracts may be divided into two classes—EXECUTORY and EXECUTED.

A contract is said to be executory when some condition remains to be performed. It is an engagement to do or not to do a particular thing. All contracts are or have been executory.

A contract is said to be executed when all the conditions have been performed and nothing remains to be done. An unpaid note is an example of an executory contract, but when paid it becomes an executed contract.

The chart on page 62 of Chapter Five shows that a contract may be discharged "by performance." When all the conditions to a contract have been performed the contract is discharged. These conditions may be classified according to the time at which they should be performed, and are known as (a) PRECEDENT CONDITIONS, (b) CONCURRENT CONDITIONS, and (c) SUBSEQUENT CONDITIONS.

A Condition Precedent exists when some condition must be performed by one party before the other party becomes obligated to perform his part of the contract, or when some condition must be performed before a contract exists.

A Condition Concurrent exists when a condition must be performed by one party at the same time that the other party is required to perform some other condition of the same contract. The one party must perform or offer to perform the conditions imposed by the contract, at the time the demand for performance is made upon the other party. Otherwise, the other party cannot be said to have committed a breach.

A Condition Subsequent exists when the occurrence of some fact will destroy the contract in the event it happens, provided the parties have expressly agreed thereto.

Sunday Contracts. Contracts made on Sunday are void or at least unenforceable under statute law in practically all the states. Statute law forbids work, labor or business on Sunday, unless it can be shown that they relate to works of mercy, charity or necessity. Examples of Sunday contracts which are usually

enforceable, are such as the providing of food or medicine in cases of emergency or for the performance of services under unavoidable physical conditions which would entail serious loss or injury if deferred. However, contracts made on Sunday and ratified on a "business" day or contracts delivered on a "business" day and to take effect from delivery and not from execution are good and enforceable. Contracts or agreements are illegal which are entered into on Sunday to be performed on a week day, or which are entered into on a week day to be performed on a Sunday.

Contracts by Correspondence. An offer may be made by mail, or by telegraph, as well as in person or through an agent or representative. It may be accepted in the same manner unless the offer specifies the method of acceptance. An offer may be conditional and one of the conditions may relate to the method of acceptance in which case the condition must be complied with. In fact, all the conditions of an offer must be accepted before a contract is made. In other words, an acceptance must be unconditional.

A person who offers to contract is known as the offeror, and the person to whom an offer is made is known as the offeree. The offeror may specify the time in which an offer must be accepted, otherwise the offer must be accepted within a reasonable time. An offer made by letter or telegraph may be withdrawn by a subsequent communication provided it reaches the offeree before he has accepted.

As soon as the acceptance is placed in the hands of the telegraph company or mailed, a contract exists. That is, when the letter has been mailed, or has been dispatched by the telegraph company, and cannot be withdrawn. If the acceptance is not made by the same method as the offer, then the contract does not exist until acceptance is received. The carrier is the agent of the offeror and is responsible to him for the delivery of the acceptance.

A. THEORY QUESTIONS

1. What is depreciation? What items in a business are subject to depreciation? How is it ascertained? C. P. A. Ark.

2. Name three methods of computing depreciation on machinery, buildings, etc. How should such depreciation be shown on the Balance Sheet? C. P. A. Ohio

3. A corporation makes a practice of charging to expense and carrying to depreciation reserve account every half year, a certain percentage of the book value of its plant and machinery.

Should repairs and renewals be charged to Profit and Loss, or can they properly be charged to depreciation reserve accounts? Give reasons in full. C. P. A. Mass.

4. How should a re-appraisal of capital assets be treated on the books of a going concern.

(a) When it involves an appreciation?

(b) When it involves a depreciation?

Is such appreciation or depreciation a consideration which should be reflected in a return of net income to the federal authorities for income and excess-profits tax purposes?
Inst. Ex. 1918.

5. Give some general principles which will guide you in determining whether too much or too little provision has been made for depreciation of buildings, machinery, tools, goodwill, patents, franchises, etc. Would a flat rate cover all these assets satisfactorily? Inst. Ex. 1918.

6. You are asked by a client to discuss with him the question of reserves for depreciation and depletion of his various capital assets. State your position on this subject and enumerate the consideration you would advance in support thereof. Would you or would you not be guided by the rules laid down by the internal revenue authorities in deciding the rates to be used? Inst. Ex. 1918.

7. Explain the relationship between a sinking fund and an allowance for depreciation. It is claimed that in municipal enterprises the requirement that rates must be high enough to provide both for a sinking fund to pay off the bonds and also for a "Reserve for Depreciation" with which to replace the plant results in a double charge to consumers. Criticize or explain this theory. Inst. Ex. 1917.

8. On pointing out the insufficiency of the provision for depreciation on machinery, which the directors admit, you are met with the argument, supported by evidence, that the real-estate values have appreciated to an even greater extent than the entire depreciation of other assets. As this latter is not taken up on the books you are asked to allow the one to offset the other. Give reasons for your agreement or disagreement.
Inst. Ex. 1918.

B. ACCOUNTING PROBLEMS

1. The officers of a company of which you are the auditor elected by the stockholders, submit to you for audit a Balance Sheet in which the following item appears:

Miscellaneous reserves (including premium on stock) $248,000.00. On investigation you find the item is made up as follows:

General reserve	$86,000.00
Operating reserves	6,000.00
Provision for plant depreciation	46,000.00
Provision for amortization of leaseholds	40,000.00
Provision for bad debts	36,000.00
Premium on capital stock sold	34,000.00
	$248,000.00

What recommendation would you make to the officers and what course would you take if your recommendation were not followed? Inst. Ex. 1917.

2. A machine costing $10,000.00 was estimated to have a life of ten years, with a residual value of $1,000.00. At the close of each year a charge of $900.00 was made and a similar amount credited to "reserve for depreciation." Just prior to closing the books at the end of the tenth year the machine was discarded and sold, bringing $2,000.00, and a similar machine was bought costing $15,000.00. Give the journal entries that you would make to close the books at the end of the tenth year in order to cover these transactions and to make the necessary adjustments. Interest is not to be calculated.

Inst. Ex. 1917.

3. You are an auditor engaged by a corporation to audit their accounts. At the beginning of the period you are to cover, the following statement is drawn from the books:

Capital		$100,000.00
Surplus		1,000.00
Accounts Receivable	$10,000.00	
Buildings after deducting $5,000.00 for depreciation	35,000.00	
Machinery after deducting $5,000.00 for depreciation	55,000.00	
Cash	500.00	
Stock on hand	500.00	
	$101,000.00	$101,000.00

During the period which you are auditing, you find buildings and machinery charged with $10,000.00 which was to cancel the entries of depreciation.

The entries were authorized according to the minute book, but not entered correctly in the general books. Formulate the necessary entries for the bookkeeper. Explain what method had been used in recording the depreciation previously charged off. Can you suggest a better method? Do you think that, under any circumstances, it is wise to charge the depreciation, previously charged off, back to the asset accounts? Explain fully.

C. P. A. Mich.

4. In your examination of the Automobile Delivery Truck account of a company, you find the following entries:

AUTOMOBILE TRUCKS

1914			1914		
Jan. 1	Trucks 1, 2, 3, 4, @ $1200.	$4,800.00	Aug. 1	Truck 2	$ 900.00
July 1	Truck 5	1,500.00	Sept. 1	Truck 4	750.00
Aug. 1	Truck 6	1,500.00	1	Balance	6,150.00
		$7,800.00			$7,800.00

The reserve for Depreciation for Automobile Delivery Truck account stood credited on January 1, 1914, with $1,800.00.

Upon analyzing the transactions represented by these items you find the following facts:

(a) Truck 5 purchased July 1 replaced Truck 1. The portion of the reserve for depreciation accumulated on January 1 for Truck 1 amounted to $900.00. Truck 5 was purchased on open account.

(b) Truck 2 was traded in for $850.00 on the purchase of Truck 6 costing $1,500.00. The difference was paid in cash. The reserve which had been accumulating for depreciation on Truck 2 on January 1, amounted to $300.00.

(c) Truck 4 was totally destroyed in an accident Sept. 1. The reserve for depreciation on this truck amounted on January 1 to $300.00.

Assume the rate of depreciation to be 25% per year.

Give journal entries which would properly record the above facts and show the balances of all accounts affected, as of September 1, 1914. C. P. A. Mich.

(Note. You are not asked to make correcting entries for those already on the books but you are asked to make entries which will properly record the transactions.

Be sure to charge Operating Expense and credit the Reserve for Depreciation account for the amount of depreciation from Jan. 1, 1914, to the date of the transaction. This should be done before recording the transaction.

In order to determine the proper balance of the Reserve for Depreciation account on Sept. 1, 1914, it will first be necessary to set up the depreciation on trucks 3, 5 and 6.)

C. LEGAL QUESTIONS

(Note. The following questions are all taken from examinations held by the American Institute of Accountants and are, therefore, of the highest professional standard. They are given as a review.)

1. When can an offer to perform a contract be withdrawn?

2. What is a tender to perform a contract and what are its effects?

3. (a) Define mistake and give its effect on contracts.
   (b) Define misrepresentation and state its effect.

4. When may a creditor enforce a contract with a minor?

5. A, in New York City, wrote B, in Buffalo, offering certain goods for sale at a certain price. B wrote a letter to A accepting the offer and posted in Buffalo. Before A received the letter he received a telegram from B stating that he withdrew the acceptance. Was a valid contract made? Explain the principles involved. Yes

Same means of Communication then Contract valid when letter mailed.

Chapter Eleven

CURRENT LIABILITIES

Liabilities are the financial obligations of a firm. They may be divided into two principal classes, Current and Fixed.

Current liabilities are those obligations that mature in a short period of time. They are usually undergoing a constant change. There should be sufficient current assets owned by a firm that may be realized upon quickly, if necessary, in order to liquidate the maturing current liabilities. It is in this connection, a banker is always concerned, when considering a request for a loan. The current liabilities may be divided into four classes—unsecured, secured, contingent and accrued liabilities.

A Balance Sheet audit for credit purposes is more concerned with the current liabilities than with the fixed liabilities. The banker does not extend credit to merchandising or trading concerns with the view of furnishing additional capital, but rather to enable them to carry a large stock-in-trade during a busy season, or to enable them to discount their accounts payable at a time when the company's quick assets are composed largely of stock-in-trade and accounts receivable.

Banks advance money on short time or call loans and, naturally, the current assets of the borrowing company must be such that it is apparent sufficient funds may be realized to liquidate all current liabilities.

Of course, the auditor must satisfy himself that all the fixed liabilities are properly stated, otherwise he could not certify as to the actual financial condition of the business.

ACCOUNTS PAYABLE

Accounts payable appear in the Balance Sheet as current liabilities. Different terms are applied to these accounts, such as Purchases Ledger accounts, Creditors' accounts, Vouchers Payable, etc.

1. ACCOUNTING THEORY

Accounts with Creditors. These accounts may be kept in the general ledger, but it is customary to keep only a controlling account in the general ledger and to keep the individual accounts in a subsidiary ledger, known as a purchases ledger or creditors' ledger.

The Purchases Ledger. It is important that only accounts payable for purchases be recorded in this ledger. These accounts should represent trade creditors. Liabilities on account of accrued interest, taxes, wages, etc., should appear in the Balance Sheet as separate items and should not be included with accounts payable.

The Purchases Ledger Controlling Account. When a separate ledger is kept with accounts payable, a controlling account should be kept in the general ledger and the balance of the controlling account should show the same results as the total of the balances of accounts in the subsidiary ledger. The purpose of this controlling account is to make the general ledger self-balancing and to enable the general ledger bookkeeper to prepare a Trial Balance from the general ledger without the necessity of first ascertaining the balances of all the individual accounts payable. It also separates the work of the bookkeepers and by planning the work so that the individual ledger bookkeeper does not have access to the general ledger, it will constitute an internal check on his work.

To establish a subsidiary purchases ledger and a controlling account for same in the general ledger, assuming that the accounts with creditors have previously been kept in the general ledger, make a journal entry as follows:

Accounts with Creditors.............	xxxxx.xx	
Purchases Ledger Controlling Acct..		xxxxx.xx
To establish a subsidiary ledger for accounts with creditors. See schedule following:		

Each creditor's account in the general ledger is debited with the amount shown in the schedule and should then balance. After posting the total amount of accounts payable to the credit of the controlling account, each individual account in the purchases ledger should be credited with the proper amount as shown in the schedule. After the entry has been properly posted, the balance of the controlling account will equal the total of the balances of the accounts in the purchases ledger.

After the purchases ledger has been opened and the accounts all transferred from the general ledger, these accounts will be debited and credited from the books of original entry in the usual manner. However, special columns will usually be created in the original books of account so that only the totals of these columns need be posted to the controlling account in the general ledger.

The Voucher System. One frequently hears of the voucher system of bookkeeping. As a matter of fact it is not a system of bookkeeping at all, but is a method of recording invoices representing all expenditures incurred, whether for material, labor, indirect expenses, selling expenses, administrative expenses, and even for additions to the plant, equipment, etc.

It is said to be a combination of the purchases book and the purchases ledger, but this is rather an exaggeration. It is true, however, that with the voucher system in use, it is customary to dispense with the purchases ledger. In fact, this is the means of its representing a considerable saving of time. There is also a saving in time in the distribution of the various charges to materials and expenses.

The Voucher Jacket. Every invoice received, after being approved for receipt of goods, prices, and extensions, might be marked with the names of the accounts to be charged and the amount chargeable to each. The invoice might also be given a number from the voucher register. It can readily be seen that to indicate all this information on the invoice itself would be anything but good practice. Therefore, it is customary to use a form especially prepared for this purpose. This form is called a voucher jacket or an accounts payable voucher. It provides for recording the number of the voucher, name of the creditor, date, amount, and classification of the items listed in the invoice for which the form is made. There is also provision for information as to the date and method of payment. The names of the accounts most frequently affected are printed on the form so as to save time and facilitate proper classification.

The Voucher Register. This book contains columns for the voucher number, date of invoice, date and method of payment, vouchers payable credit, and a series of money columns for the various accounts to be debited. A sundry column is provided for unusual accounts. After the invoice is received and has been approved, it is placed in the voucher jacket or attached to the accounts payable voucher, often together with the purchase requisition, purchase order, and material received sheet and is then recorded in the voucher register and properly filed with the unpaid vouchers, usually under its due date. When the invoice becomes due it is removed from the file and after the check has been written, it is recorded on the voucher jacket or accounts payable voucher and then filed among the paid vouchers. Of course, a memorandum is made in the voucher register showing date and method of payment. This check is then recorded in the cash book where a special column for vouchers payable is provided for.

The Vouchers Payable Controlling Account. This account takes the place of the Purchases Ledger Controlling account and is in itself a controlling account for vouchers payable. This account is credited for the total of the vouchers payable column in the voucher register and is debited for the total of the vouchers payable column in the cash book. The balance of the account represents a current liability. When all invoices have been paid the account will balance. The balance of this account may be verified by preparing a list of the unpaid vouchers.

The advantages of this system have already been pointed out. No purchases or creditors' ledger is required. Most of the expense accounts need be posted but once a month and then the total only is posted from the voucher register. The voucher jacket may contain a complete history of the purchase transactions from the time the requisition is made until the check issued in payment therefor has been cancelled and returned from the bank.

On the other hand, the system has its disadvantages. Partial payments on invoices, that is, payments on account, are practically impossible. Furthermore, this system does not readily show the total present balance due a given creditor, neither does it show the total amount of business done with a creditor for a given period. Of course, ledger accounts with individual creditors might be kept in connection with the voucher system, but in this event the saving in time, for which the system is noted, would be lost. Under certain conditions the voucher system may be used advantageously, but under other conditions its use is often burdensome.*

Classification of Accounts Payable in Balance Sheet. The Federal Reserve Board requires that the accounts payable be divided and classified in the Balance Sheet under unsecured accounts as follows:

Accounts Payable for Purchases (not yet due).....xxxxx.xx
Accounts Payable for Purchases (past due).......xxxxx.xx
Accounts Payable to Stockholders, Officers, or Employees..............................xxxxx.xx
(See Model Balance Sheet for credit purposes, page 41, Chapter Three.)

2. AUDITING THEORY.

Quoting from the Federal Reserve Bulletin on Uniform Accounting:

Verifying Accounts Payable. "A list of balances due on open accounts must be prepared and carefully checked with the ledger accounts, care being taken to see that no open account on the ledger has been omitted from the list. It should be ascertained that the balances represent specific and recent items only. When any account does not appear regular, a statement should be obtained from the creditor. If there are many such accounts in dispute, and they amount to so large a sum as to

(***Note.** In this discussion of the voucher method for handling invoices, there has been no attempt to explain the many variations of the systems that will be encountered in practice. It has not been considered necessary to illustrate the different forms and ruling of the books used as these are shown in any bookkeeping text that is at all up-to-date. We refer you to "20th Century Bookkeeping and Accounting," Part IV, for a complete discussion of all the principles involved and for illustrations of the voucher jacket, voucher check and vouchers payable book. Similar information should be obtainable from any standard text on bookkeeping and accounting.)

affect appreciably the total of current liabilities, the general causes for the disputes should be inquired into and note made of the matter for the consideration of the banker.

Voucher Systems. "In concerns with modern voucher systems accounts payable are easily verified, as all liabilities are then included in the books when incurred. Care should be taken, however, to see that all goods received on the last day of the fiscal period, as shown by the receiving records, and also all goods that were in transit and belonged to the concern on that date, are included as liabilities, and the corresponding assets included in the inventories. This test is necessary, as an increase in the accounts payable may have a very important bearing on the financial position of the concern if the cash on hand is small.

"Monthly expenses outstanding can usually be ascertained by a comparison of the expenses of the last month of the fiscal period with previous months, and those of the year with the previous year. The voucher record should, however, be examined for the months subsequent to the close of the fiscal year, in case any expenses included therein are applicable to the fiscal period under audit.

Detecting Unstated Liabilities. "When a first-class voucher system is not in operation, the auditor must take additional precautions to satisfy himself that all liabilities are included in the accounts, among which may be mentioned:

"(1) Payments made in the months subsequent to the date of the fiscal period as shown by the cash book, which should be carefully scrutinized to see that none of them is applicable to the period under review.

"(2) The file of bills not vouchered or entered on the books should be examined to see that none of them belongs to the period under audit.

"(3) A careful perusal of the minutes of a company may further assist the auditor in determining liabilities.

Purchase Contracts. "When a company has large purchase contracts in force for future deliveries they should be examined, for if the contract prices are greater than market prices, it might be necessary to set up a reserve for this loss. Any debit balance due to advance payments on such contracts or to any other cause should be shown on the Balance Sheet under a separate heading.

Consignment Purchases. "If the business under audit is one where there is any possibility of goods having been received on consignments, and part or all of such goods having been sold without a liability therefor having been shown in the books, the auditor must use all due diligence to cover the point fully. This may readily happen, as consignment accounts are usually treated as memoranda only.

"If inquiry develops the fact that goods have been received on consignment, all records in connection therewith should be called for. If the goods have all been sold, the consignor's account should show the full amount due, and if the debt is a current one, the amount will appear among accounts payable due to trade creditors. Where only part of the goods have been sold, the net proceeds due to the consignors should be shown on the Balance Sheet under the caption of 'Accounts payable consignors.'

Certificates. "As an additional precaution against the omission of liabilities, a certificate should be obtained from the proper officer or member of the concern stating that all outstanding liabilities for purchases and expenses have been included in the accounts of the period under review or of former periods. In many cases it is also advisable to obtain a certificate from the president stating that all liabilities for legal claims, infringements of patents, claims for damages, bank loans, etc., have been included, as he may be the only executive officer of the company to know the extent of such obligations."

NOTES PAYABLE

Notes payable are usually classed as current liabilities in the Balance Sheet. Under this title will usually be included drafts, notes and trade acceptances. There need be no attempt to keep separate accounts with drafts and notes. To do so would only be a waste of time for the information given is of no practical value. Some bookkeepers still use the term "bills payable." This matter was discussed on page 66 of Chapter Five, undei the heading of "Terminology."

Mr. Walton, in the November, 1919 number of The Journal of Accountancy, in writing upon this subject, says:

"The accounting profession has not differentiated as yet between notes payable and bills payable.

"In England and in continental Europe drafts or bills of exchange have been a more customary method of handling credit transactions than notes payable. In England, where most of our accounting terminology originated, bills of exchange were much more common than notes; therefore, they used the term bills payable and bills receivable, and whenever a few notes were given they were entered in the account with the bills.

"In this country the custom has been exactly the reverse. We have been accustomed to giving notes rather than accepting bills of exchange; but we have used the English terminology of bills payable until recent times. Realizing that the term bills payable was not as appropriate in this country as in England, a movement has been on foot to change the terminology from bills payable to notes payable and this movement has met with considerable success so that the term notes payable rather than bills payable now frequently appears in Balance Sheets.

"Strictly speaking a promissory note is a note payable; a trade acceptance is a bill payable; but I am inclined to think that as trade acceptances become more prevalent they will be recorded in a Trade Acceptance account rather than a Bills Payable account.

"The statement that notes payable should always bear interest is not correct. Interest is an immaterial detail which may be found in a bill of exchange or trade acceptance as well as in a note and is not essential to either. In an accounting sense, bills payable are always notes or acceptances payable at a future date, and the term does not include cheques or sight drafts.

"The objection to the term bills payable is that in this country many business men not being accustomed to bills of exchange think the term refers to the bills rendered by their creditors which are payable every month."

1. ACCOUNTING THEORY

Recording Notes Payable in Original Books of Account. Like notes receivable, there are two principal methods of recording drafts and notes. The first method is to record them in the general journal and to keep a memorandum record in an auxiliary notes payable book. This memorandum record does not constitute a posting medium as all posting would be done from the journal. The notes payable book should provide columns showing date given, number, drawer or endorser, maker or drawee, payee, where payable, due date, amount, rate of interest and when paid.

Notes Payable Book as a Posting Medium. The second method is to record drafts and notes in a notes payable book instead of the journal and so arranging the record that it not only shows a complete record of the drafts and notes, but also constitutes a posting medium. In addition to all the columns mentioned under the first method described above, there should also be columns provided to enable the bookkeeper to post the totals to the proper accounts in the ledger. This may vary somewhat depending upon the particular system of accounts in use, but usually there will be columns headed notes payable credit, interest debit, interest credit, purchases ledger debit and general ledger debit.

Notes Payable Account. This account may show individual entries for each note and draft recorded in the books of account. However, if the second method for recording notes is followed, then this account will be a summary account. It will be credited for the total of the notes payable column in the notes payable book and will be debited for the total of the notes payable column on the credit side of the cash book. If no special column is provided in the cash book, then it will be debited for the individual notes recorded therein.

Trade Acceptances Payable. Trade acceptances receivable were discussed on page 66 of Chapter Five. The method of recording trade acceptances payable should be similar to that for recording trade acceptances receivable. Reference to the Model Balance Sheet for credit purposes on page 41 of Chapter Three will show that acceptances made for merchandise and raw material should be stated separately. Therefore, it will readily be seen that if a separate account is kept in the general ledger, it will not be necessary to analyze the Notes Payable account to determine this information. If a separate account is kept, it will either be necessary to record them in the general journal or provide a special trade acceptances book similar to the notes payable book described under the second method on page 167 of this chapter.

Classification of Notes Payable. In preparing a statement for credit purposes, the Federal Reserve Board requires that notes payable be classified in the Balance Sheet as follows:

1. Notes given for merchandise or raw material purchased	xxxxx.xx
2. Notes given to banks for money borrowed	xxxxx.xx
3. Notes sold through brokers	xxxxx.xx
4. Notes given for machinery, additions to plant, etc	xxxxx.xx
5. Notes due to stockholders, officers, or employees	xxxxx.xx

These are known as "unsecured liabilities." Notes and accounts payable, secured by liens on inventories, or by securities deposited as collateral, should be stated separately as "secured liabilities." (See page 41 of Chapter Three.)

2. AUDITING PROCEDURE

Quoting from Federal Reserve Bulletin on Uniform Accounting:

"Under this caption appear notes payable and drafts accepted. Schedules should be prepared under the subcaptions, and in columns headed:

"Date of making the notes or drafts.
"Due dates.
"Names of creditors.
"Collateral hypothecated.
"Additional endorsers.
"Interest accrued to date of audit.
"Notations of renewals (as information of this nature furnishes a guide to the state of the concern's credit.)

"The schedule must be compared with the notes payable book and the total of the aggregate must agree with the balance of the ledger account of notes payable.

"Statements must be obtained from all banks and brokers with whom the concern does business, showing all notes and drafts discounted or sold by them for the benefit of the concern. These statements when received must be checked against the loans shown on the concern's books and approved in the minutes of the company.

"Inasmuch as a note is a negotiable instrument, care must be taken to see that all of those recorded as paid during the year under audit have been properly discharged, and the canceled notes are the best evidence of this fact.

"Careful attention should be given to the collateral deposited for loans, and statements as to the existence of such collateral should be obtained from the holders thereof. Such hypothecation of any of the concern's assets should be accounted for on the Balance Sheet.

"When practicable, the auditor might suggest to the client the advisability of drawing notes payable on blanks bound in a book, like a check book, with a stub for each blank, the blank and the stub to bear identical numbers. The officer, or officers, signing the notes could, in such case, initial the stub as a certificate to the amounts, payees, and terms of the notes issued. If this were done, the auditing of bills payable would be greatly facilitated."

CONTINGENT LIABILITIES

It has previously been pointed out that a Balance Sheet audit involves the detection of all unstated liabilities as well as verification of those appearing on the books of account. The discovery of contingent liabilities is not a simple matter and is often almost impossible, especially where an attempt has been made to conceal them.

Many an individual or firm has suffered a loss and even became bankrupt because of being compelled to meet obligations which did not arise out of the usual operation of business, obligations which did not in any case appear on the books of account. Almost everyone is familiar with some instance wherein an individual or firm who had endorsed a note only as a matter of accommodation, and later through unforeseen circumstances was compelled to meet it because of the inability or failure of the maker to do so.

The author recalls an experience of an audit of a manufacturing company. During the course of the audit we learned that another company had brought suit on the basis of infringement of patent rights. This company had purchased certain patent rights costing several hundred thousand dollars and had set up the cost as an asset, and was charging this off over a period of years based on the life of the patents. Further investigation revealed the fact that the result of the suit was quite uncertain. The company had been using these patented machines for several years. The plaintiff asked for damages based on the total production of the machines. We called

attention to this action in our report and advised that a fund be set aside out of profits until such time as the court had reached a decision. Several months later our client lost the suit and was forced to pay several thousand dollars damages. It will be seen, therefore, that contingent liabilities are likely to become real and an auditor must be very careful to make every effort to detect them.

Auditing Procedure. (Federal Reserve Bulletin.)

"It is not enough that a Balance Sheet shows what must be paid; it should set forth with as much particularity as possible what may have to be paid. It is the duty of an auditor who makes a Balance Sheet audit to discover and report upon liabilities of every description, not only liquidated debts but possible debts. The following are the usual forms under which contingent liabilities will be found:

Endorsements. "Inquiry of the officers or partners of the concern should be made as to whether any endorsement of outside paper has been made and as to any security received to protect the concern. Such inquiry should be particularly strict if it is known that any of the officers or partners are interested in other enterprises.

Guaranties. "Similar action should be taken in the matter of guaranties.

Unfulfilled Contracts. "Contracts to accept the delivery of goods contracted for before the date of the Balance Sheet, may call for the payment of large sums of money within a short time. In the case of raw materials, for a manufacturer, this might be a perfectly legitimate reason for seeking a temporary loan pending production and sale, but for a merchant whose Balance Sheet shows a large stock of goods on hand, it might indicate a real liability impending with assets of a doubtful character to offset it. In every audit, therefore, the auditor should call for copies of all orders for future delivery, and if such orders call for stock in excess of the current and reasonable prospective demand, mention should be made on the Balance Sheet and a report submitted, the details depending upon the circumstances of each particular case.

"Items other than those arising from the specific hypothecation of current assets should appear as a footnote on the liability side of the Balance Sheet, the total amounts being stated for each subheading and such additional report made as will convey clear information to the banker."

It will be seen, therefore, that there are two different methods for classifying contingent liabilities. Those based upon "specific hypothecation of current assets" should be listed on the credit side of the Balance Sheet among the secured liabilities. These are contra entries because the hypothecated items also appear among the current assets.

Such contingent liabilities as accommodation endorsements, actions or suits pending against client, guaranties, etc., should at least be mentioned in a footnote on the liability side of the Balance Sheet and should be accurately outlined in the report to the client.

ACCRUED LIABILITIES

All accrued liabilities should be classed as current liabilities in the Balance Sheet. These are not difficult to ascertain as they can be accurately determined and the amount calculated from the accounting records.

Auditing Procedure. (Federal Reserve Bulletin.)

"Under this caption are grouped such items as interest, taxes, wages, etc., which have accrued to the end of the period under audit, but are not due and payable until a later date. The verification of such items can be accurately made from the books and records. Special attention may be directed to the following:

Interest Payable. "Many of the liabilities which appear on a Balance Sheet carry interest. Such items as bonds and notes payable are obvious, but the auditor should also consider the possibility of accounts also bearing interest, as enough book accounts, when past due, to bear interest to warrant inquiry being made. Loan accounts of partners and officers of corporations almost invariably bear interest; also judgments, overdue taxes, and other liens.

Taxes. "The amount of accrued State and local taxes can be ascertained from an examination of the latest tax receipts; though in some cases, as the period for which the taxes are paid is not shown on the face of the receipt, it may be necessary to make inquiries of the proper taxing authorities as to the period covered.

"Under the Federal Income Tax Law a tax is imposed upon the net profits of a corporation, which must be paid even if the corporation is dissolved before the end of the year during which the tax is imposed. As the tax is specifically based upon the net profits of a particular period, although payable some months thereafter, the tax accrues throughout the specified period, and if a net profit is disclosed upon the closing of the books at any date during the year, a reserve equal to the amount of the accrued tax must be shown on the Balance Sheet.

Wages. "Where the date of the Balance Sheet does not coincide with the date to which the last pay roll of the period under audit has been calculated, the amount accrued to the date of the Balance Sheet must be ascertained and entered as a liability, unless such amount is trifling. It will suffice to take the proportion of a full week's pay roll (six days) without reference to possible daily variations.

Water Rates, Etc. "Where bills for such expenses as water, gas, etc., are not rendered monthly, the auditor must enter the accrual of the proper proportion since the last bill as a liability.

Traveling Expenses and Commissions. "It is important to note whether the accounts of all traveling salesmen have been received and entered before the books are closed. The auditor should secure a list, and if any report was not so entered, provision should be made for it unless the amount is likely to be trifling.

"Ample provision should be made for all commissions eventually payable on sales which have been billed to customers. As commissions are frequently not payable to salesmen until the sales have been collected from the customers, accrued commissions are often omitted from the books. As they must, however, be paid out of the proceeds of the sales on which the full profit has already been taken into the accounts, they should be set up as an accrued liability.

Legal Expense. "All concerns have more or less litigation. Before the books are closed the lawyers should be requested to send in a bill to date. If one is not found, the auditor should ascertain the amount, if any, probably due and set it up as an accrued liability.

Damages. "If the concern is insured against liability for damages to employees or the public, a proportion of the premiums paid in advance for the unexpired time covered by the insurance will appear in 'Deferred charges.' But there may be claims or suits for other damages not covered by insurance, and where the auditor finds any evidence which leads him to suspect there may be liability of this nature he should insist upon being informed of all the facts. He can then form an opinion as to the amount that should be set up as an accrued liability, or, if the outcome is uncertain, as a reserve against possible loss."

LEGAL PHASES

(**Note.** In connection with the discussion of contingent liabilities on account of accommodation endorsements, it is appropriate to quote from the negotiable instruments law which regulates endorsements of negotiable instruments.)

What Constitutes Negotiation. An instrument is negotiated when it is transferred from one person to another in such manner as to constitute the transferee the holder thereof. If payable to bearer it is negotiated by delivery; if payable to order it is negotiated by the endorsement of the holder and completed by delivery.

Endorsement; How Made. "The endorsement must be written on the instrument itself or upon a paper attached thereto. The signature of the endorser, without additional words, is sufficient endorsement.

Kinds of Endorsement. "An endorsement may be either special or in blank, and it may also be either restrictive or qualified, or conditional.

Special Endorsement. "A special endorsement specifies the person to whom, or to whose order the instrument is to be payable; and the endorsement of such endorsee is necessary to the further negotiation of the instrument.

Blank Endorsement. "An endorsement in blank specifies no endorsee, and an instrument so endorsed is payable to bearer and may be negotiated by delivery.

Restrictive Endorsement. "An endorsement is restrictive, which either:

1. Prohibits the further negotiation of the instrument; or

2. Constitutes the endorsee the agent of the endorser; or

3. Vests the title in the endorsee in trust for or to the use of some other person.

But the mere absence of words implying power to negotiate does not make an endorsement restrictive.

Qualified Endorsement. "A qualified endorsement constitutes the endorser a mere assignor of the title to the instrument. It may be made by adding to the endorser's signature the words 'without recourse' or any words of similar import. Such an endorsement does not impair the negotiable character of the instrument.

Conditional Endorsement. "Where an indorsement is conditional, a party required to pay the instrument may disregard the condition and make payment to the endorsee or his transferee, whether the condition has been fulfilled or not. But any person to whom an instrument so endorsed is negotiated will hold the same, or the proceeds thereof, subject to the rights of the person endorsing conditionally.

Striking out Endorsement. "The holder may at any time strike out any endorsement which is not necessary to his title. The endorser whose endorsement is struck out, and all endorsers sudsequent to him, are thereby relieved from liability on the instrument."

A. THEORY QUESTIONS

1. What steps should an auditor take to insure, so far as possible, that accounts presented to him for audit contain all the liabilities of the company? Inst. Ex. 1917.

2. Outline the work which should be done in connection with notes and bills payable in an audit for credit purposes of a merchandising company. Inst. Ex. 1918.

3. How would you ascertain whether a Balance Sheet contains all the liabilities for purchases of supplies and raw material? C. P. A. Ind.

4. What are contingent liabilities? Should they be embraced in a Balance Sheet? Give an example. C. P. A. Ind.

5. State three kinds of contingent liabilities. How should they be shown on the Balance Sheet? C. P. A. Mass.

6. (a) What different methods should be employed in books of account for keeping track of notes endorsed for accommodation and notes endorsed in the regular order of business?

(b) How would you indicate in books of account the contingent liability arising in each case? C. P. A. Mich.

7. Describe the voucher system and state some of the advantages and disadvantages of the system. Inst. Ex. 1918.

8. You find that a group of accounts receivable have been assigned to secure a loan. Does that affect the value of any other creditor's claim in case of failure before the loan is paid? Should any reference to the fact be made in your report? How would you set up that fact in the Balance Sheet? C. P .A. Mich.

B. ACCOUNTING PROBLEMS

Balance Sheet

December 31, 1916

ASSETS

Cash		$ 3,000.00	
Accounts receivable		15,700.00	$18,700.00
Inventories:			
Finished goods		154,500.00	
Goods in process		8,350.00	
Materials		55,000.00	217,850.00
			236,550.00
Land		40,000.00	
Buildings	$94,000.00		
Less reserve for depreciation	14,000.00	80,000.00	

(*Concluded on next page*)

Machinery and fixtures.....	81,000.00		
Less reserve for depreciation..............	21,000.00	60,000.00	180,000.00
Deferred charges:			
Insurance and taxes..........................			1,100.00
Total assets...................................			417,650.00
Deficit..			52,850.00
			$470,500.00

LIABILITIES

Notes payable..........................	$275,000.00	
Accounts payable....................	15,500.00	$290,500.00
Capital stock:		
Preferred........................	100,000.00	
Common........................	80,000.00	180,000.00
		$470,500.00

The foregoing was the Balance Sheet of a corporation, December 31, 1916, incorporated January 1, 1910, and during the ensuing year the following transactions occurred:

Sales, net......................................	$550,000.00
Purchases, net—raw material....................	347,000.00
Raw material inventory increased...............	64,000.00
Labor..	60,000.00
Total manufacturing expense....................	35,900.00
Process inventory increased.....................	20,000.00
Finished goods inventory decreased..............	36,000.00
Total selling expense............................	35,000.00
Total administrative expense....................	26,000.00

Notes payable have been renewed as they became due, except that $100,000.00, held by the largest owners in the company, has been donated to the company, July 1, 1917..................................	$100,000.00
$5,000.00 of 3½% Liberty Bonds have been bought..........................	5,000.00
$2,000.00 has been donated to the Red Cross..............................	2,000.00

Notes:

Depreciation on buildings, estimated life 47 years, beginning January 1, 1910.

Depreciation on machinery, estimated life 27 years, beginning January 1, 1910.

Accounts receivable were $45,000.00, and accounts payable $15,000.00 at the close of the year.
There was accrued interest payable $2,500.00, December 31, 1917.

Prepare Trial Balance and Balance Sheet as on Dec. 31, 1917.
Inst. Ex. 1918.

(**Note.** It will be necessary to set up skeleton ledger accounts to obtain a Trial Balance. No information is given as to the amount of interest paid during the year. The date and method of acquiring the Liberty Bonds is not shown. Since this information is not given in the problem, you may ignore the element of interest. You may assume that the same amount of insurance and taxes is to be deferred as at the end of the previous year.)

C. LEGAL QUESTIONS

1. How are negotiable instruments negotiated?
C. P. A. Mich.

2. A note non-negotiable in form is executed and delivered by A to B and endorsed by B to C. A refuses to pay it when due, claiming want of consideration. C brings suit against A averring that he was a holder in due course. Can A successfully defend the action if want of consideration is established? Give reasons. Inst. Ex. 1918.

3. A negotiable note executed and delivered by A to B passes in due course to and is endorsed in blank by B, C, D and E; F is the last holder and strikes out C's endorsement. What is the liability of C, D and E on their endorsement?
Inst. Ex. 1918.

4. As an accommodation to B, A on June 1, 1918, endorsed B's note for $1,000 payable to C's order on July 1, 1919. On July 2, 1919, C endorsed and delivered the note to D. What rights, if any, has D against A? Inst. Ex. 1919.

5. New York, April 10, 1916.
Thirty days after date I promise to pay to the order of C. D. One Hundred Dollars.
(Signed) A. B.
Endorsed in blank "without recourse." C. D.
What does the endorser warrant by his endorsement?
Inst. Ex. 1917.

Chapter Twelve

FIXED LIABILITIES

"Any debt the maturity of which extends beyond the period adopted within that business for current liabilities will usually be grouped with the fixed liabilities, there seldom being an intermediate group."—Kester.

In Chapter Two, page 27, we quoted from the Public Service Commission of New York on what comprised "Funded Debt." Long-term obligations, usually in the form of mortgaged or bonded indebtedness, are called fixed liabilities—sometimes known as LOAN CAPITAL as distinguished from SHARE CAPITAL.

Loan capital usually has as security some specific form of property, such as land, buildings, equipment, etc., which have been classified and included among the fixed assets of the concern. Under these circumstances the general creditors can only claim the equity or difference between the realizable value of the specific portion of the assets, and the amount of the loan which has been secured by it.

When it becomes necessary or advisable to raise additional capital and it is not desired to increase the share capital, long time notes or bonds, usually secured by mortgages, are issued. In the case of an individual or a partnership, it is quite customary to issue notes secured by first or second mortgages on the fixed assets or real property owned, but in the case of a corporation it is more common to issue bonds.

MORTGAGES

Definition. A mortgage is a conditional title to property given by the owner to another to secure the payment of a debt or the discharge of some obligation. It is similar to a deed and conveys title to the property on which the mortgage is placed, but upon some condition. That condition is the failure to make prompt payment of an obligation or debt at maturity. The tendency is to regard a mortgage as a lien on the property and not as an actual conveyance. The mortgagor retains physical possession of the property and is entitled to the income therefrom and may use the property just as though it were his own. Of course, he must not impair its value and he must comply with all the conditions in the mortgage contract. The holder of a mortgage (the mortgagee) has practically no control over the property or over the operation of the concern involved.

Real or Personal Property May Be Mortgaged. "In equity, whatever property, real or personal, is capable of an absolute sale, may be the subject of a mortgage."*

Mortgages on chattel property are usually for a short period of time and are classed as current liabilities, but mortgages on real property as security for notes or bonds, due at some time in the future beyond that for which liabilities are classed as current, would be considered fixed liabilities.

Kinds of Mortgages. Mortgages are known as either chattel or real estate mortgages, depending on the property which is the basis of the security. They are sometimes known as purchase money or building and loan mortgages, depending on the purpose of the mortgage. They may also be classified as to precedence as first mortgages, second mortgages, etc. A first mortgage takes precedence over a second mortgage and so on. In case of liquidation of capital assets, holders of mortgages stand in order according to the class of mortgage held.

Chattel Mortgages. The only difference between a chattel mortgage and a real estate mortgage is in the kind of property conveyed as security. Chattel mortgages are placed on chattel or personal property. Real estate mortgages are placed on real property.

Purchase Money Mortgages. These are mortgages given for part or the whole of the purchase price of land. They take precedence over all claims of the general creditors. The mortgage may be given either to the person from whom the land is purchased or to a third person.

Building and Loan Mortgages. These are frequently given to secure funds for erecting a building. The money is paid over as the building is constructed and reaches certain stages mentioned in the mortgage contract, or the entire amount may be delivered to a trust company to be held in trust and paid over as the installments fall due. If the money is held by the mortgagee and paid in installments, interest can only be charged from the date of the actual payment of the installments, but if placed in the hands of a trust company to be paid in installments, interest may be charged on the full amount. Of course, the trust company will also pay a low rate of interest on the amount deposited.

Accounting Procedure. Mortgages used as security for notes are usually classed as mortgages payable on the books of account, while those used as security for bonds are classed as bonds payable. The usual procedure with mortgages payable is the same as with notes payable. The Mortgages Payable account is credited with each mortgage issued and debited when the mortgage has been paid. These transactions will usually be found recorded in the general journal and cash book. They are not sufficiently numerous to require special columns and, therefore, all items are posted individually.

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*Wright v. Shumay, 30 Fed. Cases, No. 18,093; 1 Biss. 23-26.

Unlike bonds, mortgages are seldom sold at either a discount or a premium. The amount received is usually equal to the face of the mortgage, hence mortgages should be recorded, like notes, at their face or par value. In other words, the interest rate on mortgages is nearly always equal to the effective market rate for the particular type of equity involved.

BONDS

Definition. A bond is simply a long-term note—an interest bearing, negotiable instrument, under seal, promising to pay a certain sum of money at a definite or determinable future date. It is usually secured by a pledge of certain properties, real or personal, as to either or both principal and interest.

Bonds vs. Notes. A corporation may borrow money the same as an individual. If only a small amount is desired or it is wanted for a short time only, notes are usually given. These notes may be secured or unsecured. If unsecured, they are classed as current liabilities and are called notes payable on the books of account. If secured by a mortgage, they are usually called mortgages payable on the books of account and may be classed as either current or fixed liabilities, depending on the length of time to maturity.

When the amount to be borrowed is large and is wanted for a long period of time, say from five to fifty years, then bonds instead of notes are given. There is said to be a bond issue. This consists of a number of bonds, which may vary in denomination, but which are all of like general tenor, and if secured are all secured alike under one "deed of trust".

Deed of Trust. This is a mortgage on certain specified property placed in the hands of a trustee who represents the bondholders. The deed of trust states at length the terms and conditions under which the bonds are issued and under which the property for their security is held. In the bonds, reference is made to the deed of trust by which they are secured. It will be seen, therefore, that both the deed of trust and the bonds issued refer to each other in such a manner that all terms and conditions are clearly stated in both instruments. The trustee has the right to act in behalf of the bondholders and may bring foreclosure proceedings if it becomes necessary to do so. If the trustee fails to do so, any bondholder may bring foreclosure proceedings for the benefit of all the bondholders. Of course, he must show the court that this action is necessary to safeguard the interest of the bondholders and that the trustee refuses to act.

Security. Formerly bonds were commonly supposed to be secured by real estate mortgages, except when otherwise specifically designated. In these times, bonds may or may not be secured at all. Often they are nothing more than promissory notes; in fact, are not so valuable because they do not mature for a longer time. It will be readily seen, therefore, that an

auditor must be able to determine the value of the security in order to place a valuation on the bonds.

There are so many different kinds of bonds that we can only describe a few of each kind here. They may be subdivided as to security, as to purpose, as to payment of interest, and as to payment of principal.

AS TO SECURITY

Debenture Bonds. We have already stated that bonds may be secured or unsecured. Unsecured bonds are usually termed "Debentures" or "Debenture Bonds." This term is also often used to describe bonds partially secured, those secured by collateral and those on which the payment of the interest is contingent upon the earnings of the company. This interest may be cumulative or non-cumulative.

An unsecured debenture bond is a mere promise to pay and is inferior to any secured liabilities of the company. It is, however, superior to preferred stock in that the liability on account of interest payable ranks ahead of the dividends on the preferred stock. The value of unsecured bonds depends entirely on the financial strength of the issuing company. No foreclosure proceedings can be instituted because no mortgage has been given. Bonds secured by depositing stocks and bonds of another company (owned by the issuing company) in the hands of a trustee, are frequently known as "collateral trust bonds" and may be classed as debentures as stated above.

Example: Lake Shore & Michigan Southern 25-year debenture 4s, due September 1, 1928, were originally debentures, but are now secured by direct second lien on the Lake Shore property of New York Central System.

Mortgage Bonds. Mortgage bonds, as the name implies, are those secured by a mortgage, or deed of trust on part or all of the property of the issuing company. These bonds may be known as first, second, third, etc. mortgage bonds according to the rank of the mortgage or deed of trust by which they are secured. A first mortgage bond is a first lien on the property mortgaged except in cases where a builder's lien, receiver's certificate or some similar obligation takes precedence. A second mortgage bond is one in which the security is a second mortgage on the same property.

Example: American Smelting & Refining First Mortgage 5s, due April 1, 1947, secured by first mortgage on entire property of company and by pledge of capital stock of five subsidiaries.

Income Bonds. These have already been defined as bonds on which the payment of interest is contingent upon the earnings of the issuing company. Such bonds are a lien on the net income of the company. If there are no net profits, the interest is not a liability unless it is cumulative. The principal of such bonds may be secured or unsecured. If unsecured they are frequently called debenture bonds.

Guaranteed Bonds. These are bonds the payment of which, either as to principal or interest, or both, is guaranteed by another company. This guarantee to be binding must be in writing and must be written on the bond itself, or be attached to it. Such bonds are frequently issued. For instance, a subsidiary company may issue bonds guaranteed by the parent or holding company of which it forms a part.

AS TO PURPOSE

Improvement Bonds are bonds issued for the purpose of property improvements. They may be either debenture or mortgage bonds and may be secured or unsecured as to principal or interest, or both.

Example: Miami Conservancy District, Ohio, 5½% bonds, issued December 1, 1917, "for the prevention of floods and protection of certain cities, including Dayton, Hamilton, Middletown, Piqua, Troy and other smaller municipalities."

Refunding Bonds are bonds issued to raise funds to replace or redeem other bonds which are maturing. In some instances they are exchanged directly for the old bonds, but more often sold and the money used to retire the maturing bonds. The interest rate on these bonds may be higher or lower than on those bonds being retired, depending on money conditions at the time of issue.

Example: Illinois Central Refunding Mortgage 4s, due November 1, 1955. Secured by a direct mortgage on 21,172 miles of road, etc.

Adjustment Bonds are bonds issued for the purpose of readjusting or consolidating existing indebtedness. They are very similar to refunding bonds.

Purchase Money Bonds are bonds given to secure funds with which to purchase the property by which they are secured. (See Purchase Money Mortgages, Page 178.)

AS TO PAYMENT OF INTEREST

Registered Bonds are registered on the books of the issuing company in the name of some particular individual or company in much the same manner as capital stock. The interest and principal are then payable only to the registered holder of the bonds. Such bonds may be transferred by assignment. When assignment is made the assignee surrenders the old bond and is given in exchange a bond issued in his own name. The transfer is made on the books of the issuing company.

Coupon Bonds are bonds usually made payable to bearer and to which are attached interest coupons. These interest coupons are always made payable to bearer. They are clipped off at maturity and presented for payment. There will be as many coupons attached as there are interest due dates. United States Government Liberty and Victory Bonds are issued in

both registered and coupon forms. The advantages of the coupon bonds is the ease with which they may be transferred. They are transferrable by delivery alone, while the registered bonds are transferrable by assignment only. A disadvantage of coupon bonds is that if lost or stolen, the finder or holder may dispose of them easily and once in the hands of an innocent holder they become valid. If a registered bond is lost or stolen, it is practically impossible to realize on it because it is payable only to the party named in the bond and could only be transferred by assignment which would require forgery. This forging would, therefore, prevent a valid transfer. Both coupon and registered bonds are often issued under the same security or deed of trust. Coupon bonds are often subject to being registered if desired. A bond may be registered as to principal only and the interest may be payable in the form of coupons. In this event interest is payable to whoever holds the coupons, but the principal is payable only to the party registered and named in the bond.

Participating Bonds are bonds in which it is specified that the holder is to share in the profits of the issuing company. A certain rate of interest may or may not be specified and the holder may share in the net income the same as actual stockholders. These are sometimes known as income bonds. (See page 180.)

AS TO PAYMENT OF PRINCIPAL

Gold Bonds are bonds which expressly provide for payment in gold. Such provisions are legal and enforceable. If no medium of payment is specified, legal tender is assumed.

Convertible Bonds are bonds which carry the right of conversion into other securities of the same company. Usually convertible bonds may be exchanged for common or preferred stock within a certain time and at a fixed rate of exchange.

Example: American Telephone and Telegraph, 7-year convertible 6s, due August 1, 1925, convertible at par into common stock of the company at $106.00 per share after August 1, 1920.

Serial Bonds are bonds issued in series, one series payable each year until the entire issue has been redeemed or retired. It will be seen, therefore, that the security back of these bonds increases in proportionate value as each series of the bonds is redeemed. In some instances the terms of the issue provide for relinquishing a part of the security after certain redemption stages are reached.

Callable or Redeemable Bonds are bonds that may be redeemed by the issuing company before the maturity date fixed by the deed of trust. Often a sinking fund is established and the bonds are redeemed or called in and then cancelled. Sometimes the issuing company, instead of establishing a sinking fund, simply calls in a part of the bonds periodically and cancels them. Many bond issues contain provision to the

effect that upon any interest date (previous notification having been given) they may be redeemed, all or in part, at a stated price plus accrued interest.

Example: Chesapeake & Ohio, 20-year convertible 4 ½s, due February 1, 1930. Callable for redemption after February 1, 1920.

Procedure in Issuing Bonds. The following is a brief outline in general of the various steps to be taken in a bond issue. Of course, a great deal will always depend upon the kind of bonds being issued, the purpose of the issue and the conditions of the issue. (It is understood that this outline is subject to statutory regulations in the various states and that a bond issue should always be made under the direction and supervision of competent attorneys familiar with the statutes.)

(1) **Meeting of Directors.** A preliminary meeting of the Board of Directors is held and a resolution passed recommending a bond issue. A special meeting of the stockholders is then called. The stockholders usually have the authority to authorize the bond issue, but even where the directors have that authority it is common and good practice to get the endorsement of the stockholders.

(2) **Meeting of Stockholders.** At this meeting a statement of the proposed issue is submitted for consideration. This statement stipulates all the conditions of the issue, the time the bonds are to run, the security, terms of payment, rate of interest, redemption conditions, etc. After due consideration a resolution is passed. Often this resolution is voted upon by submitting it to the individual stockholders after this meeting. In other words, the vote is obtained by mail.

(3) **Bond Issue Authorized.** After the bond issue is approved by the stockholders, the directors hold another meeting and pass a formal resolution authorizing the bond issue in due form by the officers of the corporation.

(4) **Proposed Issue Submitted to Public Service Commission.** In states where a Public Service Commission exists, bond issues of all corporations coming under its direction must have its approval before issuance.

(5) **The Deed of Trust.** A trustee is selected. This is usually a trust company. The proper officers of the issuing company draw and duly execute a deed of trust, conveying certain properties to the trustee, and setting forth all the conditions under which the bonds are issued. If real estate is conveyed, a copy of the deed of trust must be filed in every county where the real estate is located.

(6) **Preparation of Bonds.** The bonds are usually engrossed and coupons are attached, if the issue is of coupon bonds. The trustee's certificate appears on the bonds. The form of certificate appearing on the back of the bonds of the United States Steel Corporation reads as follows:

"THIS IS TO CERTIFY that this bond is one of the issue of bonds of United States Steel Corporation mentioned in the indenture dated April 1, 1903, within referred to, executed by United States Steel Corporation to the undersigned as Trustee.

United States Trust Company of New York.

By____________________"

(7) **Sale of Bonds.** The bonds may be sold direct to the public or may be sold through some firm of bankers. Provision for selling the bonds is usually arranged for before the bond issue is authorized or soon thereafter.

(8) **Provision for Paying Interest and for Redeeming the Principal.** Some definite provision must be made for the payment of the interest and for the redemption of the bonds at maturity. This latter is usually provided for in the deed of trust, but a method of establishing a fund from which to meet these obligations must be arrived at.

1. ACCOUNTING THEORY

Bond Account. The object of this account is to show the amount of bonds authorized by the deed of trust. The account is charged for the par value of the bonds redeemed and cancelled, and is credited for the par value of the bonds authorized by the deed of trust. It will be seen that the difference between the two sides of the account represents the par value of bonds authorized and not yet cancelled.

Unissued Bond Account. The object of this account is to show the par value of the unissued bonds, that is, those bonds authorized but not yet sold. The account is charged for the par value of the bonds authorized and is credited for the par value of bonds sold and issued. The balance of this account deducted from the balance of the Bond account will show the par value of bonds outstanding

Bond Subscription Account. The object of this account is to show the total subscriptions for bonds on the installment plan. Usually the bonds are not issued until all installments have been paid in full; therefore, this account is credited for the par value of bonds subscribed for and is charged for the par value of subscribed bonds when issued. The balance of the account represents the par value of bonds subscribed for but not yet issued.

Bond Premium Account. The object of this account is to show the amount in excess of the par value realized through the sale of the bonds. When the bonds are sold above par the excess is credited to this account. The account should be written off during the life of the bonds.

Bond Discount and Expense Account. The object of this account is to show the cost of the issue. All expenses* incident to the bond issue and the difference between the amount realized and the par value of the bonds, when sold below par, are charged to this account.

If desired, separate accounts may be kept with "Bond Discount" and "Bond Expense." Bond discount is considered an addition to the amount of interest paid but should be prorated over the life of the bonds.

Bond Interest Account. The object of this account is to show the interest paid on bonds. At the end of each fiscal period, or oftener, this account is closed into the Profit and Loss account.

Relation of Bond Premium or Discount to Interest. The premium received or the discounts allowed upon the sale of bonds is said to represent a deduction from, or an addition to, the interest paid on the bonds.† If the bonds sell at a discount, the borrower pays not only the interest but also the discount for the use of the money. If the bond sells at a premium, the principal borrowed is more than par; and since the borrower does not have to pay back the premium at maturity, the premium is really a deduction from the interest.

It will be seen, therefore, that the premium or discount should be written off over the life of the bonds by either crediting or charging a proportionate part to the Interest account and through this to Profit and Loss at the end of each fiscal period. The customary method is to credit the premiums or debit the discounts to Profit and Loss, periodically, during the life of the bonds. This is known as the Straight Line Method.

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*"All expenses connected with the issue and sale of evidences of debt, such as fees for drafting mortgages and trust deeds, fees and taxes for recording mortgages and trust deeds, cost of engraving and printing bonds, fees paid trustees provided for in the mortgages and trust deeds, fees and commissions paid underwriters and brokers for marketing such evidences of debt, and other regular expenses." —Public Service Commission, New York.

†"Premium or discount on bonds is a deduction from, or addition to, the nominal rate of interest which the bond carries; that is to say, there is a rate known as the true or effective rate, at which any corporation can place its bonds at par; if it elects to place them at any other rate, the bonds will sell at a premium or discount as the case may be; but the effective rate remains the same and this effective rate is the proper charge to Income account. Hence, the premium or discount should theoretically be spread over the term of the bonds, and the annual installment thereof credited or charged to the Income account each year."

—"Accounting Practice and Procedure," by A. Lowes Dickinson.

However, this is considered unsound accounting practice because it results in an erroneous statement of the operating costs. Proper accounting calls for a reflection of the actual interest cost spread over the life of the bonds, and this can be accomplished only by adjusting the Interest account.

Effective Rate Method. This is considered the best method of writing off bond premiums or discounts. The actual amount of interest paid is charged to the Bond Interest account. If the bonds were sold at a discount, the difference between the nominal rate (the amount actually paid) and the effective rate (the prevailing rate of interest) is also charged periodically to Bond Interest and credited to Bond Discount and Expense. If the bonds were sold at a premium, the difference between the effective and nominal rates is periodically charged to Bond Premium and credited to Bond Interest. It will be seen that this method scientifically writes off the Bond Premium or Bond Discount and Expense accounts during the life of the bonds.

2. INCOME TAX PROCEDURE

Amortization of Bond Premiums. The Treasury Department holds that the difference between the amount realized and the par value of bonds when sold at a premium, represents taxable income. It need not be rated as income for the year in which the bonds are sold, but may be prorated over the life of the bonds.

(Reg. No. 45, 1919, Art. 544, ¶2.) "If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year."

Amortization of Bond Discounts. The Treasury Department holds that discounts, commissions for selling, and other expenses incidental to issuing the bonds, represent a loss and may be prorated over the life of the bonds.

(Reg. No. 45, 1919, Art. 544, ¶3.) "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible as interest and should be prorated or amortized over the life of the bonds. If, thereafter, the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense of the taxable year. If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year."

Procedure When Bonds Issued at Par Value Are Purchased for Redemption. (Reg. No. 45, 1919, Art. 544, ¶1.) "If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

Bond Discount Considered Interest. The Treasury Department holds that the discount on bonds sold at less than par is to be treated as interest paid in advance. It would, therefore, seem that it is equally good practice to consider the premium on bonds sold above par to be a deduction against the amount of interest paid.

(Reg. No. 45, 1919, Art. 563.) "If it sells its bonds at a discount, the amount of such discount is treated as interest paid, and if it retires its bonds at a price in excess of the issuing price, such excess may usually be deducted as expense. If the Corporation sells its capital assets for less than their cost or fair market value as of March 1, 1913, the loss sustained is deductible."

Interest on Liberty Bonds Exempt from Income Tax. (Income-Tax Primer, 1919, Ques. 19.) "To what extent is interest received on Liberty bonds exempt from income tax?

(a) All interest received upon Liberty bonds is exempt from normal tax.

(b) In any event, interest upon the 3½ per cent Liberty bonds of the first series is exempt from both normal tax and surtax.

(c) In addition, a person is entitled to exemption from tax upon interest received on $5,000 aggregate amount of bonds of later issues and war-savings certificates.

(d) If one originally subscribed for Liberty bonds of the fourth series he is also entitled to an exemption from tax on interest received upon bonds of the previous issues not to exceed one and one-half times the amount of the fourth Liberty bonds originally subscribed for and still owned, not to exceed in the aggregate $45,000.

(e) The interest received on not exceeding $30,000 principal amount of Liberty bonds into which first Liberty bonds may have been converted in the exercise of any privilege arising as a consequence of the issue of the fourth Liberty bonds is exempt.

(f) The interest received on not exceeding $30,000 principal amount of Liberty bonds of the fourth issue is exempt.

The interest upon Liberty bonds, which is entirely exempt from income tax as defined above, should not be included in the gross income of the return, but should be reported in the return."

3. AUDITING THEORY

Quoting from the Federal Reserve Bulletin:

Listing Mortgages and Bonds. "A copy of the mortgages must be examined and the terms thereof noted. The amount of bonds registered, issued, and in treasury, rate of interest, and duration of the bonds, should be shown on the face of the Balance Sheet. A certificate should be obtained from the trust company certifying the amount of bonds outstanding, etc., as verification of the liability stated in the Balance Sheet. The interest on the bonds outstanding, shown in the Balance Sheet, should be calculated and reconciled with the interest on bonds, as shown in the Profit and Loss account.

Sinking Funds. "Sinking fund provisions in mortgages should be carefully noted and care should be taken to see that they are provided for in the accounts of the company, and any default noted in the Balance Sheet.

Redeemed Bonds. "Bonds redeemed during the period or previously should be examined to see that they have been properly cancelled, or, if they have been destroyed, a cremation certificate should be obtained from the trustees.

"Mortgages sometimes stipulate that the current assets must be maintained at a certain amount in excess of the current liabilities, and the auditor must give due consideration to such matters and any other stipulation in regard to the accounts, or any audit thereof, that may be referred to in the trust deed, and see that they have been complied with.

Mortgages. "As a mortgage derives its chief value from the fact that upon registry it becomes a lien, the auditor should verify the existence of such an obligation by inspecting the public records, not only with reference to such as may be found on the company's books, but also any that may still appear on the public records as unsatisfied. If the auditor lacks the necessary facilities for making a search it will be worth his while to arrange with a local lawyer or title company whereby, for a small fee, any mortgages or judgments entered against the concern under audit will be reported to him.

"In any event the auditor must verify the amount as recorded in the account, the rate, the due date, and the property covered thereby.

"It should be borne in mind that a payment on account of a mortgage must be recorded or the entire amount will remain as an encumbrance on the property. Therefore, if payments on account appear, the auditor should ascertain if they have been so recorded; if not, the fact should be noted on the Balance Sheet.

Judgments. "The same procedure should be followed in verifying judgments as in verifying mortgages. As many business men consider that the entry of an invoice is an admission of liability, and will not permit the entry of a claim which they propose to fight, it is sometimes difficult for an auditor to find any evidence of such liens. Even admitting the fact, they may still refuse to allow the judgment to be entered on the books as a liability, in which case it is proper for the auditor to include it as a footnote on the Balance Sheet as a contingent liability.

Unpaid Interest. "When considering the matter of liens it should be noted that interest unpaid is a lien as well as unpaid principal, so where the auditor finds evidence of interest on liens being in default, he should add it to the principal in each case."

4. AUDITING PROCEDURE

Investigation by the senior shows that there is $100,000.00 of the First Mortgage Bonds of the Blank Manufacturing Company outstanding. These are 5%, 20-year bonds. Interest payable semi-annually on January 15 and July 15 of each year. As shown in the Trial Balance, December 31, 1918, (see page 50, Chapter Four) $2,500.00 had been deposited for bond interest.

The policy of the company has been to charge off 5% of bond discount annually, thus distributing it over the life of the bonds on a straight line method without regard to the rate of interest which the bonds bear. The Bond Discount unamortized now stands at $6,000.00 and the Bond Interest account shows a debit balance of $5,000.00, this amount representing the amount of interest paid on January 15 and July 15, 1917.

A. THEORY QUESTIONS

1. Name five classes of bonds, describing briefly each class with regard to issue, purpose, redemption, etc.
C. P. A. Mich.

2. Do unsold bonds of a railroad company constitute a liability? If they do, under what account would they appear in the ledger? C. P. A. Mich.

3. An issue of Mortgage Bonds of the par value of $100,000.00 and running for five years has been sold at 90, the money to be used in the erection of new buildings. How should the transaction be recorded and why? C. P. A. Mich.

4. If a bond reads at 4%, but the amount which will be received is 1.05 of the nominal par, what is the actual percentage of cost income? C. P. A. Mich.

5. If a company sells its own bonds at a premium, is the premium received a legitimate profit of the company?
C. P. A. Ohio.

B. ACCOUNTING PROBLEMS

1. (a) A corporation issued First Mortgage Bonds bearing interest at 5%, dated January 1, 1917, to subscribers at $125.00 for each bond, par value $100.00. The bonds are to be paid for in three installments: $25.00 on February 1; $50.00 on March 1; and $50.00 on April 1. The February 1 and March 1 installments have been paid and the proper entries made on the cash book. You are called in to formulate the journal entries on the two installments. How would you make them? There were issued and sold $100,000.00 par value.

(b) A corporation borrows $120,000.00 for a period of ten years to pay off an existing loan at a higher rate of interest, paying therefore in brokerage and costs $2,750.00. How would you treat this item on the books? C. P. A. Ind.

2. The Smith and Jones Manufacturing Company issued $200,000.00 of first mortgage 50-year, 5% sinking fund bonds which were marketed at 98½, 1% commission, and expended the entire proceeds in the erection of their plant. The discount and commission were charged to the Unamortized Debt Discount and Expense accounts, to be subsequently charged to Profit and Loss, proportionately, during the life of the bonds. Five years later, the company was enabled, owing to a disturbance in the financial market, to purchase $50,000.00 of said bonds for Sinking Fund account at 95.

Prepare the necessary journal entries to record correctly the above transactions of the company. C. P. A. N. Y.

(**Note.** You may assume that the bonds were placed in the hands of a firm of bankers for sale. The bonds purchased for sinking fund account were cancelled by the company.)

3. The Standard Trust Company is appointed by the Peninsular Mining Company as Trustee of a Bond Issue, aggregating $1,000,000.00, all Bonds of $1,000.00 denomination, rate 5% and bearing date January 1, 1914. Bonds mature in ten equal annual installments, beginning January 1, 1917, unless previously converted or retired.

The issue is not purchased by the Trustee, but is sold through Emory Davis & Company, Brokers, the Company realizing 90% and accrued interest less the cost of appraisal of property, printing, trustees' expenses, etc., amounting to $9,310.80.

The entire issue was taken over, and paid for by the brokers on January 20, 1914.

Among other things the trust deed provides:

Bonds convertible on any interest date for 6% preferred stock at 90%, at option of holder.
Bonds may be retired out of surplus on any interest date at 103, at option of company.
Sinking fund for payment of principal only to be based on production of ore at ten cents per ton.
Trustee to charge ¼% of principal on issue, and ¼% on coupons.
Interest payable January 1 and July 1.

The company's production for three years is assumed to be, for the purpose of this problem, 1,000,000 tons per year.

January 1, 1916—$100,000.00 are converted to preferred stock.
January 1, 1917—$200,000.00 are redeemed at 103.

Formulate all necessary entries in journal form for books of:

(a) Standard Trust Company,
(b) Peninsular Mining Company,
(c) Emory Davis & Company,

which may be occasioned by the above transactions up to and including January 1, 1917.

C. P. A. Mich.

(**Note.** It would be well to review the discussion of securities and the accounting for sinking fund investments before preparing a solution to the above problem. See pages 70-76, Chapter Five.)

PRACTICE DATA

(**Note.** The following transactions are a part of special practice data designed as a test of your knowledge of the principles of accounting and auditing, and of your ability to apply the knowledge in actual practice. If you have properly learned all of the principles of accounting and auditing

taken up in this text, you should experience no difficulty in recording the following transactions in proper form and in preparing the necessary financial statements. Use ordinary journal and ledger paper. If you desire, you may use analysis paper for special statements such as the Working Sheet. As this practice data is continued in the next chapter, you should carefully preserve your working papers until you are ready to continue the work. You may now proceed by recording the following transactions in journal form.)

Transaction No. 1. The General Manufacturing Company was incorporated under the laws of the state of Ohio with an authorized capital stock of $4,000,000.00, consisting of 10,000 shares of 7% cumulative preferred stock of the par value of $100 each, and 30,000 shares of common stock of the par value of $100 each.

Transaction No. 2. Subscriptions to the capital stock were made as follows:

R. V. Williams—5,000 Shares Common and 5,000 Shares Preferred Stock.

A. B. Opfer—2,000 Shares Common and 1,000 Shares Preferred Stock.

H. W. Henry—1,000 Shares Preferred Stock.

C. H. Bowser—5,000 Shares Common Stock.

Maude E. Barnes—1,500 Shares Common and 1,500 Shares Preferred Stock.

Ruth E. Forry—2,000 Shares Common and 1,500 Shares Preferred Stock.

R. O. Wiggins—5,000 Shares Common Stock.

E. W. Atkinson—5,500 Shares Common Stock.

All of the stock was subscribed for at par, payment to be made upon demand.

To further the purposes of the new corporation, it is intended to take over the business owned and conducted by R. V. Williams under the name of the Williams Manufacturing Company. The newly organized company is to acquire all the assets, excepting cash, and to assume all the existing liabilities of the Williams Manufacturing Company. Mr. Williams is to be allowed a price equal to his present investment with no allowance for good will or other intangible assets. Therefore, Williams' subscription to the capital stock of the General Manufacturing Company is based upon this agreement.

Chapter Thirteen

NET WORTH

Business Organization. An auditor must be familiar with the different classes of business organization. A business may be conducted by an individual, an association of individuals known as a copartnership, or by an artificial body created by law and known as a corporation.

1. ACCOUNTING THEORY

The Sole Proprietorship. A business conducted by an individual is known as a sole proprietorship. The individual contributes the capital, is entitled to the profits and must stand the losses. The Balance Sheet must show the investment or capital and any increase or decrease in the investment. By reference to the formal Balance Sheet exhibited on page 41 of Chapter Three, it will be seen that the net worth of an individual should be shown thus:

(a) Capital........................xxxxx.xx
(b) Undistributed profits or deficit.... xxxxx.xx

Naturally, if the business shows a profit which has not been distributed, it constitutes an addition to the investment, but in the case of a deficit or net loss, there is a deduction from the investment.

The Copartnership. An association of individuals in business is known as a copartnership. In this class of business organization the capital may or may not be contributed equally and the profits and losses may or may not be shared equally. Hence, before the auditor can prepare the Balance Sheet he must ascertain the conditions of the copartnership agreement. It is needless to say he must also be familiar with Partnership Law. A special section of this course will be devoted to partnership accounting, therefore, we will confine this Unit to showing the classifications of partnership accounts in the Balance Sheet. This is not shown clearly in the formal Balance Sheet in Chapter Three. The following is a suggested classification of all partnership accounts for Balance Sheet purposes: (Assuming two partners and a net profit for the fiscal period.)

(a)	"Y's" capital	xxxxx.xx
(b)	"X's" capital	xxxxx.xx
(c)	Add undistributed profits	xxxxx.xx
(Assuming a deficit or net loss)		
(a)	"Y's" capital	xxxxx.xx
(b)	"X's" capital	xxxxx.xx
(c)	Deduct deficit	xxxxx.xx

It must be remembered that this discussion is confined to a Balance Sheet prepared for credit purposes. Note that it is not necessary to show the distribution of the profits or losses although this may be shown if desired. One peculiarity of the Federal Reserve Board's requirements is that a partner's personal or drawing account, when a debit balance is shown, should be classified among the secured current assets, (see item 29, formal Balance Sheet, page 40, Chapter Three), and when a credit balance is shown, should be classified among the unsecured current liabilities. (See item 18, page 41, Chapter Three.) When the account constitutes an asset, it is classified as a current asset but not as a quick asset. This distinction is due to the fact that an account receivable from a partner may be slower and more difficult to realize upon than an account due from a customer.

The Corporation. Due to the fact that the first fifteen Units of this course constitute instructions for a Balance Sheet audit of the Blank Manufacturing Company, which is a corporation organized under the laws of Indiana, we must give more space in this Unit to corporate organization than to either the individual or copartnership form of organization. No stress will be placed upon corporate law at this time, however.

Share Capital. In Chapter Twelve it was shown that there are two classes of capital, share capital and loan capital. Any capital borrowed, by means of mortgages and bonds, for a long period of time may be looked upon as loan capital, but capital contributed by the stockholders of a corporation is considered share capital. When a corporation is organized there is authorized a certain issue of capital stock. The capital stock is divided into shares and ownership of these shares is represented by stock certificates. Reference to the Chart on page 198 will show that, generally speaking, there are three classes of corporations—municipal, stock and non-stock corporations. We are concerned at this time with stock corporations.

Stock Corporations. Stock corporations may be classed as financial, business and public service. It will be seen that practically every corporation organized for profit can be classed as a stock corporation. By this is meant that the original capital for financing the business is raised principally by selling shares

of stock. A share of stock represents a proportionate interest in the net worth of a company. It will readily be seen that if a company, with an authorized capital stock of $100,000.00, sells 100 shares of stock (par value, $100.00) and receives therefor $10,000.00 in cash, each share outstanding would represent ownership of one hundredth of the net worth of the company, not one hundredth of the authorized capital stock.

Stock Issues. Stock may or may not have a specified value. If the value is specified, that value is known as its par value; if no value is specified, it is said to be stock with no par value. Most stock bears a specified par value which must be uniform for all the shares within a certain class. The par value may and does differ widely. In industrial and mercantile companies, it is generally $100.00, but in the case of mining companies the par value is more frequently $1.00. At any rate, the par value of any issue of stock is the amount specified in the stock certificate. A stock certificate also specifies the number of shares which it represents.

Stock of No Par Value. Stock of no par value may now be issued in the following states:

California	Maine
Delaware	Maryland
Illinois	New Hampshire
Ohio	New York
Pennsylvania	Virginia

When it is considered that in 1912, New York passed the first law granting the right to organize corporations with shares of stock of no specified value, there would seem to be many decided arguments in favor of capital stock without par value. Let us see what reasons are advanced in its favor. Louis Marshall recently expressed his opinion as follows:

"Eventually it will not only become a part of the jurisprudence of most of the states of the union, but in twenty years from now few corporations will be organized on any other principle.

"I believe it to be the only reasonable method of representing stock ownership in a corporation. The old method of placing an arbitrary dollar mark on a certificate of incorporation led to stock-watering, the creation of false values, and proved to be an easy medium for carrying out fraudulent schemes and practices. Under the new system every share of stock represents an aliquot interest in the corporate assets. Its value is dependent upon the actual value of the assets, and not upon any fictitious or imaginary value. That is the honest way of issuing stock. In the past a corporation which acquired undeveloped mining property issued shares of stock by the thousands and arbitrarily fixed the value of the shares at amounts which varied from $1.00 to $100.00 each. These corporations had capital stock to the amount of $1,000,000.00 or $100,000,000.00, which

had merely a potential value; but speculation was carried on with the idea that the par value had some relation to actual value. It is unnecessary for me to say that such practices are inimical to the public interest. It has now become the usual thing for corporations which are honestly managed to issue their stock without par value. The experiment has proven most satisfactory, and bankers who at first were skeptical are now found to favor the issuance of stock on this new and reasonable theory."

Accounting for Stock of No Par Value. From the standpoint of the accountant, his work is actually simplified to some extent. No account with Unissued Capital Stock is necessary. The Capital Stock account would simply be credited with the value at which the stock is issued. In other words, the Capital Stock account shows the value of the stock at time of issue. No accounts with stock discounts or premiums need be kept.

F. H. Hurdman,* C. P. A., in an address before the annual meeting of the Institute of Accountants, held in Cincinnati, Ohio, September 16, 1919, said:

"In recording stock of no par value on the books and setting up values in the statements of assets and liabilities, it does not seem that any difficulties are presented. The Capital account should reflect the value at which the stock was issued—whether for cash, property or services. The only other account representing a measure of value in the outstanding stock, outside of certain reserve accounts, would be the Surplus account. In my opinion this account should at all times represent undistributed net earnings of the corporation.

"Inasmuch as the Capital account will not generally reflect on its face the number of shares outstanding, it will be necessary to show in the Capital account itself the shares issued. It does not become necessary, as in the case of stock with par value, to carry any portion of the proceeds received from its sale to a Paid-In-Surplus account. Furthermore, the fact that stock may be issued at varying values for each share has no significance other than to raise or lower the unit or share value for every other share outstanding. Each share represents an aliquot part of the entire capital, other than that portion which may be allocated to one class of stock by virtue of preference.

"The number of shares authorized should be noted on the Capital Stock account. A separate account is, of course, unnecessary to record this fact.

"It is probable that very few cases will arise involving donated treasury stock, as that is one of the evil practices this form of legislation was designed to prevent. No reasonable object would be attained by issuing stock of no par value at a

*Of the Firm of Hurdman and Cranstoun, New York, N. Y.

nominal value and then donating a portion of that issued stock back into the treasury, presumably for sale to provide working capital. The incorporators would undoubtedly retain the required number of shares for this purpose at the time of incorporation. In the event of such a contingency arising, however, I would suggest that the number of donated shares be carried in Treasury Stock account without any money value. The number of shares indicated by this account would then be deducted from the issued shares shown in the Capital account, in order to show on the statement the actual number of shares outstanding in the hands of the public, which is the essential fact.

"When stock of this description is purchased by the company and placed in the treasury, it should be recorded in Treasury Stock account at its purchase price and shown on the statement as a deduction from Capital account at the amount paid therefor. The number of treasury shares would also be deducted from the total shares outstanding.

"In presenting the Capital account in the corporation statements the important thing is to show the number of shares issued and outstanding, with the value of these shares as reflected by the books or the statements in question."

Market Value of Stock. The market value of capital stock may and frequently does vary materially from its par value. The par value is the amount specified in the stock certificate, but the market value is what the stock actually sells for.

Capital Stock Premium Account. Stock selling above par is said to sell at a premium. Such premium should be credited to an account with Premium on Capital Stock. This represents a profit but not an operating profit for it cannot be said that the mere sale of stock above par constitutes an operating profit. Since it does not constitute an earned profit from operations, it is not available for dividends. Financial organizations nearly always consider capital stock premiums as a permanent credit to surplus. Other classes of corporations usually amortize the account by writing it off over a period of years. This is done by simply charging the premium account and crediting Profit and Loss with a proportionate part of the premium each month or year.

Capital Stock Discount Account. In most states it is illegal to sell stock at a discount. Even where it may be done legally there is a tendency to conceal the fact so far as the accounts are concerned. This is done by charging the discount to Organization Expense, or by increasing the book value of property accounts. This policy is to be condemned because to increase the book value of assets is to inflate the net worth or capital of the concern. When this is done the stock

(*Continued on page 199*)

- The Corporation
  - 1. Municipal (Public)
    - Towns
    - Counties
    - Cities
    - Villages
    - School Districts
  - 2. Stock (Private)
    - (a) Financial
      - National Banks
      - State Banks
      - Savings Banks
      - Trust Companies
      - Investment Companies
      - Stockbrokers
      - Bldg. & Loan Associations
    - (b) Business
      - Insurance
        - Fire
        - Life
        - Accident
        - Health
        - Liability
        - Marine
      - Manufacturing
      - Publishing
      - Mining
        - Gold
        - Coal
        - Zinc
      - Trading
        - Wholesale
        - Retail
      - Transportation
        - Automobile
        - Aeroplane
      - Theatrical
      - Hotels
      - Personal Service
        - Lawyers
        - Doctors
        - Accountants
        - Architects
        - Engineers
    - (c) Public Service
      - Steam Railroads
      - Electric Railways
      - Shipping
      - Elec. Light & Power
      - Water
      - Telephone
  - 3. Non-Stock (Private)
    - Idealistic
    - Religious
    - Charitable
    - Benevolent
    - Educational
    - Cooperative

NOTE: The above classification is intended to illustrate the various classes of business enterprises, both public and private, that may be organized in corporate form. No attempt has been made to make the list exhaustive, but it is complete enough to be fairly illustrative. It is subject to many variations. For instance: Private educational enterprises may be organized as Stock Corporations, in which case they should be classed under business enterprises and as such are conducted for profit. Usually Non-Stock (Private) Corporations are not conducted for profit.

is said to be "watered." Kester*, in discussing Discount on Stock, says:

"In the State of New York the stock of a corporation cannot be sold below par. Where sale below par is allowed, the proper booking of the discount requires consideration. The Interstate Commerce Commission requires that discounts or premiums be shown on the books under those titles, i. e., Discount on Capital Stock and Premium on Capital Stock. This method is to be commended as being true to fact and presenting a full and sufficient record of the facts. In the case of other concerns over whose accounting practices there is no regulation, that method is honored more in the breach than in the observance. A prevalent feeling is that the appearance on a Balance Sheet of such an item as discount on stock is a serious reflection on the standing of the corporation and is to be avoided in any way possible. Discount on stock is not an attractive item on a Balance Sheet, but there is little justification for such sentiment in those states where the sale of stock at a discount is a perfectly legitimate transaction. The Balance Sheet ought to represent facts as they are until they change; then the new conditions should be shown. So long as the discount on stock remains a fact it should be so shown. When the discount has ceased to exist through its absorption against premium on stock or the general surplus, it should no longer be reported because it is then a matter of ancient history with which the present is not concerned.

"A favorite method of charging the discount on stock to organization expense is not approved, not because it is a misnomer, for discount may well be looked upon as one of the expenses of organization, but because it is an item of sufficient importance and interest to require separate record. Charging the discount to some asset account, when payment of stock is made by property instead of by cash, is to be severely condemned. Inflation of asset values to cover up such an item cannot be justified."

Organization Expense Account. The expenses incurred in the organization of a corporation are usually charged to this account and then amortized over a period of years. Such expenses as the following are usually charged to this account:

(a) Incorporation fees, fees of attorneys, accountants, etc.

(b) Promoter's services, underwriting expenses, cost of printing and circulating prospectuses, cost of soliciting subscriptions, cost of engraving and printing stock certificates, etc.

Generally speaking, all expenses actually incurred in the organization of a corporation up to the time of actual operation, constitute proper charges to Organization Expense.

The account should undoubtedly be written off in a reasonably short period of time. It is not considered good practice

*Accounting—Theory and Practice, Volume Two.

in this country to capitalize such expenditures permanently though it is sometimes done. Montgomery says:

"In some respects sentiment is changing as to the wisdom of spreading these expenses over more than two years. The best practice is to charge off immediately everything which has no tangible or residual value. It is a fallacy to assume that stock certificates, incorporation expenses, etc., have any of the attributes of an asset; and so the sooner the cost appears in the Expense account, the better."

However, it is to be noted that our best authorities do not agree with regard to the time over which these expenses should be distributed. Bennet* says:

"Such expenses are absolutely essential to the creation of the business, and the first year receives no more benefit from the expenditure than the fifth or sixth. It would, therefore, seem more equitable, so far as the statistical feature of bookkeeping is concerned, to write such expenses off over such a period of years as the management may elect. Probably five years would be sufficient for this purpose, in which case one-fifth of the total amount should be charged off each year."

Classification of Capital Stock. There are many classes of stock. We shall simply define briefly each of the more common classes.

Preferred Stock. In an attempt to make stock issues an attractive investment, often a certain class of stock is given some preference over another class. Stock may be preferred as to assets or dividends or both. The most common plan is to issue stock preferred as to dividends. By this is meant that the preferred stockholders are entitled to their dividends before the common stockholders share in the profits. If stock is preferred as to assets, in case of dissolution, the preferred stockholders are entitled to their interest ahead of the common stockholders, but in no case do the preferred stockholders' claims rank ahead of any outside claims. All preferred and general outside creditors must first be satisfied. Preferred stock may be either cumulative or non-cumulative.

Cumulative Preferred Stock. Preferred stock designates a certain minimum rate of dividend, but if the net profits of the company are not sufficient to pay the dividend, the preferred stockholders are no better off than the common stockholders. If, however, the stock is designated as cumulative, the holder is entitled to the dividend each year or as soon thereafter as the net earnings of the company justify the distribution of a dividend. The owners of preferred cumulative stock must be satisfied before the owners of common stock may share in the profits at all.

*In his treatise on "Corporation Accounting."

Non-Cumulative Preferred Stock. Ordinarily, preferred stock is cumulative, but it is not infrequent to find a specification to the effect that the preferred stock is non-cumulative. In this case the owners of preferred stock will not receive dividends for the current period unless the net earnings are sufficient to pay the rate of dividend specified.

Common Stock. Stock which is evidence of ordinary ownership in the corporation is known as common stock. After preferred stockholders' claims have been satisfied as to dividends, the common stockholders have a right to the remainder of the net earnings. In dissolution they are only entitled to the residual capital, after all other obligations have been settled. It is seen, therefore, that common stock may be either superior or inferior to preferred stock, depending entirely upon the earning power of the company.

Participating Preferred Stock. In addition to specifying a minimum rate of dividend, preferred stock may also participate in any dividend in excess of its own specified minimum.

Non-Participating Preferred Stock. When preferred stockholders do not share in any dividends in excess of the rate specified, the stock is said to be non-participating. It will be seen that the best possible class of stock, so far described, would be participating, cumulative, preferred stock —stock preferred both as to dividends and assets.

Guaranteed Stock. One company may guarantee the stock of another company. A large company may enter into a contract of lease with a smaller company and guarantee a certain rate of dividend to the stockholders of the smaller company. Such a guarantee constitutes a liability in the form of a lien on the guarantor company, regardless of the amount of the net earnings. Any stock said to be guaranteed by the issuing company is misleading for a company can only legally pay dividends out of earned profits and cannot, therefore, guarantee its own stock.

Founders' Stock. This class of stock does not exist in the United States but in England. Stock is sometimes issued to the promoters and it is specified that this stock shall share dividends out of proportion to the ratio which they bear to the total issue of common stock. For instance, this stock might be entitled to one-half more dividends than shall be given to the other stockholders of common stock.

Debenture Stock. The Public Service Commission of New York defines debenture stocks as "those issued under

contract to pay absolutely thereon at specified intervals a specified return." It will be noted that such stock is similar to debenture bonds, see page 180, Chapter Twelve. Debenture stock is a debt of the corporation and does not resemble stock as used in this country, hence has not proven popular here. Debenture stocks on account of their being similar to debenture bonds should be classified among the fixed liabilities in the Balance Sheet.

Watered Stock has already been referred to as representing stock which has a higher nominal value than the true or actual value of the properties for which it was issued. It is usually given in payment of services or as a bonus with bonds. Stock which has been "watered" tends to mislead the public as to its actual value.

Donated Stock. Any stock donated by the stockholders back to the issuing company may be termed donated stock. The object in donating stock back to the company is to secure additional working capital through its sale. Donated stock is stock which has usually been issued as fully paid to holders at inflated values. At the time it is donated to the issuing company, usually a transaction is entered on the books at a nominal figure, charging Donated Stock account and crediting Working Capital account. This donated stock is usually offered as "treasury stock at less than par" and represents assets, the value of which has been inflated. It may be sold at par, or at a discount or premium, or may be given away as a bonus in connection with the sale of unissued stock or bonds.

Forfeited Stock. When subscribers to capital stock fail to make payment as per agreement, the stock may, in some cases, be declared forfeited. Payments already made on forfeited stock constitute a surplus of a permanent nature. This is generally held not to be available for dividends as it does not represent an earned profit.

Bonus Stock. Any stock issued as a gift to purchasers of preferred stock or bonds constitutes bonus stock. It is usually treasury stock, otherwise the recipient would be liable for the par value of such stock which fact might make it an unwelcome gift, to say the least.

Treasury Stock, strictly speaking, represents stock which has been issued and later acquired through purchase by the issuing company or stock donated back to the issuing company by the stockholders. There should be a clear distinction between unissued stock and treasury stock. In some states unissued stock cannot be sold at less than its par value, but this can in no way affect the sale of true treasury stock because such stock has already been issued and may now be reissued as fully paid treasury stock at any price which it may command.

Pro-Forma Journal Entries Incident to Capital Stock Transactions

Opening Entries. There is a lack of uniformity with regard to accounting practice in recording opening entries for corporate organizations.

Transaction No. 1. Let us assume that the A. B. Company has been formed under the laws of Ohio. A charter has been secured and there is an authorized capital stock of 10,000 shares with a par value of $100.00 each, being divided equally into common and preferred stock.

At this point the following entry should be made:

Unissued Capital Stock, Common	$500,000.00	
Unissued Capital Stock, Preferred	500,000.00	
Authorized Capital Stock, Common		$500,000.00
Authorized Capital Stock, Preferred		500,000.00
(Explanation.)		

This entry is to set up accounts with the Authorized Capital Stock and with the Unissued Capital Stock. Some authorities do not open accounts with the Unissued Capital Stock except in case all of the capital stock has not been subscribed for. However, it will readily be seen that the method shown above is logical and practical—it enables anyone to determine readily from the ledger the amount of the authorized stock of each class, and by comparing the Authorized Capital Stock accounts with the Unissued Stock accounts, it is a simple matter to determine the amount of stock of each class actually outstanding.

Transaction No. 2. Subscriptions to the capital stock have been made as follows:

A—1,000 Shares Common and 1,000 Shares Preferred Stock.
B—500 Shares Common and 500 Shares Preferred Stock.
C—1,000 Shares Common Stock.
D—100 Shares Preferred Stock.
E—25 Shares Common and 25 Shares Preferred Stock.

These subscriptions to the capital stock had all been secured at the time the corporation was formed, but the stock has not been paid for nor issued, hence the transaction may be set up as follows:

Subscriptions to Capital Stock, Common	$252,500.00	
Subscriptions to Capital Stock, Preferred	162,500.00	
Capital Stock Subscribed, Common		$252,500.00
Capital Stock Subscribed, Preferred		162,500.00
(Explanation.)		

Transaction No. 3. Upon call the subscribers to the capital stock make the following settlement:

A pays for his stock in full by giving title to certain real estate.

B, C and D pay for their stock in cash.

E gives a 30 day note in payment of his stock. Stock certificates are issued to all subscribers.

This transaction may be recorded as follows:

(a)

Real Estate	$200,000.00	
Cash	210,000.00	
Notes Receivable	5,000.00	
Subscriptions to Capital Stock, Common		$252,500.00
Subscriptions to Capital Stock, Preferred		162,500.00
(Explanation.)		

(b)

Capital Stock Subscribed, Common	$252,500.00	
Capital Stock Subscribed, Preferred	162,500.00	
Unissued Capital Stock, Common		$252,500.00
Unissued Capital Stock, Preferred		162,500.00
(Explanation.)		

It will be seen from the above entries that as soon as the stock previously subscribed for has been issued, it is necessary to make an entry crediting the Unissued Stock accounts. This is necessary because the difference between the Unissued Stock accounts and the Authorized Stock accounts should always represent the exact amount of stock issued and outstanding.

2. AUDITING THEORY

Quoting from the Federal Reserve Bulletin:

Capital Stock. "As a rule trust companies are the transfer agents for the capital stock of large corporations and for verification purposes it is sufficient to obtain letters from them certifying to the capital stock outstanding.

"Where companies issue their own stock, the stock registers and stock certificate books should be examined and compared with the lists of outstanding stockholders.

"On the Balance Sheet each class, if more than one, of stock must be stated, giving amount authorized, issued, and in treasury, if any. In the case of companies with cumulative preferred stocks outstanding a note must be made in the Balance Sheet of the dividends accrued but not yet declared.

"If stock has been sold on the installment plan, the auditor should ascertain that the calls have been promptly met and whether any are in arrears. If special terms have been extended to any stockholder, approval of the board of directors is necessary and the minutes should be examined accordingly.

"If any stock has been sold during the period under audit, the auditor should verify the proceeds of the sales."

A. THEORY QUESTIONS

1. (a) Name the various forms of Capital Stock, with full explanation.

(b) What is the meaning of Watered Stock and how should it appear on the books? C. P. A. Mich.

2. How is the value of capital stock determined? C. P. A. Ark.

3. Mention and explain two common views concerning the treatment of donated capital stock. Inst. Ex. 1918.

4. In making up a Balance Sheet should the capital invested be included in the liabilitites? State your reasons. C. P. A. Ohio.

5. How should the losses on shares of stock issued at a discount be dealt with in the accounts of a corporation? C. P. A. Ind.

6. What is treasury stock, and state the difference, if any, between that and stock authorized but not issued. At what price may either be sold? How should they appear on the books of account? C. P. A. Ind.

7. In its prospectus a corporation represents that it has an issue of "cumulative, non-voting, non-participating, six per cent preferred stock".

Give your interpretation of this expression. C. P. A. Mass.

8. What are organization expenses? How are they to be treated in accounts? At what point do expenses cease to be organization expenses and become operating expenses? Inst. Ex. 1918.

9. To what extent may the "organization expenses" of a corporation be regarded as a permanent asset and how should this account accordingly be dealt with? C. P. A. Me.

10. Is the deficiency in the early years of a corporation's activities (whether an actual loss or a deficiency between the earnings and the normal rate of return) similar to organization expenses? How should such deficiencies be treated in the accounts? To what extent is such a deficiency similar to interest paid during construction? Should such deficiencies be carried on the Balance Sheet? If so, should they be written off, and how and when? May the deficiencies representing the difference between actual earnings and normal rate of return be capitalized, in the strict sense of having capital stock issued to a corresponding sum? State clearly just who is affected, and how, by the different methods of treating the items mentioned above. Inst. Ex. 1917.

B. ACCOUNTING PROBLEMS

1. A Massachusetts corporation temporarily in need of funds makes the following arrangement with three of its directors. They individually pledge their stock, par value $15,000, $10,000, and $5,000, and receive loans of $7,500, $5,000, and $2,500, with which they purchase new stock at par. It is their intention, when the loans are paid by the corporation to return this $15,000 worth of stock.

(a) May this stock be purchased by the company?

(b) What should be the entries on the books of the corporation? C. P. A. Mass.

2. A company organized with $1,000,000 capital stock which it placed at par, and $1,000,000 5 per cent bonds which it sold at 90, this being a 6 per cent basis. It paid to contractors, etc., for construction $1,800,000 and this amount of investment ran, on the average, for one year before the property was ready for operation. When operation began the company had therefore paid one year's interest on the issue of bonds. No dividends were paid on the stock. In addition to the sum named above the company also paid $10,000 for legal expenses in connection with incorporation and $5,000 for franchise and other fees.

How should the accounts appear when the property was ready for operation? Formulate journal entries and post to skeleton ledger accounts. Inst. Ex. 1917.

3. A corporation having issued its capital stock at par buys 1,000 shares at 95. It later sells 500 of these shares at 98, and 300 at 85, and 200 at 101. Give the journal entries covering these transactions.

How should the items appear on the Balance Sheet immediately after purchasing the stock, and immediately after each of the sales? Inst. Ex. 1917.

4. In auditing the Smith Manufacturing Company's books, you find in going through their minutes that a resolution was passed to give away one share of common stock with every share of preferred stock sold. At the end of their fiscal year, which period you are asked to audit, their books show as follows:

Real Estate and Buildings	$ 83,872.88	
Cash on Hand in Bank	1,063.06	
Machinery and Tools	10,000.00	
Fixtures	452.18	
Unearned Insurance	160.94	
Office Supplies	397.86	
Manufactured Goods on Hand	10,000.00	
Accounts Receivable	16,840.62	
Capital Stock, Preferred		$ 37,500.00
Bills Payable		13,100.00
Accounts Payable		14,601.43
Mortgage Loan on Real Estate		35,000.00
Profit and Loss Account		22,586.11
	$122,787.54	$122,787.54

What comments would you make to the Smith Manufacturing Company? C. P. A. Ark.

5. A corporation organizes under the laws of Michigan to conduct a manufacturing business. Authorized capital $400,000.00, half each common and preferred stock, shares $100.00. Five incorporators subscribe for ten shares each of common stock at face value. John Smith purchases from three manufacturing companies, their complete plants for $395,000.00 and transfers said plants to the incorporated company for the remaining $395,000.00 of common and preferred stock and $150,000.00 of first mortgage 5% bonds out of a total issue of bonds of $200,000.00, leaving $50,000.00 of bonds in the treasury.

Make opening journal entries and Trial Balance showing the company's condition after the transaction.

C. P. A. Mich.

PRACTICE DATA

(Continued from Chapter Twelve)

Transaction No. 3. As has been stated in Transaction No. 2, the General Manufacturing Company is to acquire all the assets excepting cash and to assume all the liabilities of the Williams Manufacturing Company. With this in view a firm of Certified Public Accountants was employed to make a Balance Sheet audit of the books of the latter company. The present investment of Williams, as shown in the accompanying Balance Sheet after deducting the cash, is $1,601,670.00. In Transaction No. 2, Williams subscribed for 5,000 shares common stock and 5,000 shares preferred stock of the General Manufacturing Company. Certificates for this stock have now been issued to Williams. The balance due Williams is to be paid later by issuing bonds. A preliminary agreement has been made whereby Williams will purchase the entire bond issue. For the present, therefore, an account with Williams is permitted to stand open until such time as the details of the bond issue may be completed. The Balance Sheet of the Williams Manufacturing Company, as certified by the accountants, appears as follows:

THE WILLIAMS MANUFACTURING COMPANY
Balance Sheet—Dec. 31, 1919

ASSETS

Bank Balance	$ 68,000.00	
Imprest Cash	1,330.00	
Accounts Receivable	89,256.00	
Notes Receivable	24,340.00	
Merchandise Inventory	223,258.00	
Land	500,000.00	
Buildings	690,000.00	
Machinery, Tools and Equipment	1,130,000.00	
Office Furniture and Fixtures	8,160.00	
Deferred Administrative Expenses	9,279.00	
Total Assets		$2,743,623.00

(*Concluded on next page*)

LIABILITIES

Accounts Payable.................$	408,000.00	
Notes Payable, Banks.............	545,000.00	
Notes Payable, Trade..............	57,000.00	
Notes Receivable Discounted (Contra)	23,623.00	
Accrued Pay Roll	30,000.00	
Accrued Salaries..................	9,000.00	
Total Liabilities....................		$1,072,623.00
R. V. Williams' Present Investment.		1,671,000.00
		$2,743,623.00

Transaction No. 4. C. H. Bowser and R. O. Wiggins pay their subscriptions to the capital stock by conveying to the company title to patents valued at $1,000,000.00. Stock certificates are issued to each.

Transaction No. 5. Following the organization of the General Manufacturing Company, it was decided to issue bonds as follows: (Bonds, par value, $1,000 each.)

First Mortgage Bonds, 5%, 20 years, $120,000.00

Second Mortgage Bonds, 6%, 15 years, $398,000.00

Debenture Bonds, 5%, 10 years, $153,000.00

R. V. Williams purchased the entire bond issue at par, thereby cancelling his account against the company, he paying the difference, $69,330.00, in cash.

Chapter Fourteen

PROFIT AND LOSS

A Balance Sheet audit comprehends the preparation of a Profit and Loss statement. When the Balance Sheet is prepared, after proper verification of all stated and unstated assets and liabilities, it will show either a surplus or a deficit. If the net worth has increased during the fiscal period, over and above any additions to the investments, there has been an addition to the surplus or undivided profits. On the other hand, if the net worth has decreased during the fiscal period, after properly considering any withdrawals from the investment, there has been a deduction from the amount of the surplus existing at the beginning of the fiscal period and if the amount of the assets are actually less than the amount of the liabilities an actual deficit will exist.

In as much as no conclusions can be definitely arrived at with regard to the causes for any changes in the net worth, from the Balance Sheet, it is necessary to prepare a Profit and Loss statement. The client will not be satisfied to simply be informed that his business has been conducted at a profit or loss amounting to a certain sum, but will naturally be even more concerned in knowing how these facts were ascertained. How were profits made or how were losses incurred? are natural questions.

To prepare an intelligent statement of profits and losses will require familiarity with the legal and economic phases of income and expense accounts, and ability to state the transactions in an intelligent manner. This implies ability to analyze the nominal accounts and to present the results so that the proper information is conveyed to the client in the best possible form.

In connection with the analyzing of income and expense accounts, and the best form for presenting the results, we will again refer to the Federal Reserve Bulletin on "Uniform Accounting."

Surplus. "The auditor should give consideration to the surplus at the beginning of the period. This item represents the accumulated profits prior to the beginning of the fiscal period under review, and should be compared with the surplus shown on the Balance Sheet of the previous year, and with the ledger account, to see that it corresponds, and if it does not, a reconciliation statement should be prepared giving full details of the differences.

Profit and Loss. "The auditor should obtain the Profit and Loss statement for three years, at least, including the period under audit, and after verifying them by comparison with the ledger account, prepare a statement in comparative form. This comparison will furnish valuable information to the banker as to the past progress of the concern under audit.

"While it would be impracticable in an ordinary Balance Sheet audit, and, at the same time, somewhat useless to make a detailed check of all the transactions entering into the composition of the Profit and Loss account, there are certain main principles to be kept in view which are briefly outlined below:

Sales. "Whenever it is possible, the quantities sold should be reconciled with the inventory on hand at the beginning of the period, plus the production, or purchases, during the period, less the inventory on hand at end of the period.

"Where a good cost and accounting system is in force, the sales records will very probably be in good shape, but nevertheless, the auditor should satisfy himself from the shipping records that the sales books were closed on the last day of the fiscal year, and that no goods shipped after that date are included in the transactions.

"When an audit is being made for the first time, the auditor should satisfy himself that the sales at the beginning of the period were recorded in accordance with the dates of shipments. Such verifications can be made conveniently by a direct comparison of the shipping memoranda with the invoices billed.

"Allowances to customers for trade discounts, outward freights, reductions in prices, etc., should be deducted from the sales in the Profit and Loss account, as the amount of net sales is the only figure of interest to the bankers.

"The future bookings at the close of the fiscal year should be looked into, as a comparison of orders on hand with corresponding periods of other years furnishes the bankers with an idea of the concern's business outlook.

Cost of Sales. "The inventory at the beginning of the period, plus purchases during the period, less inventory at the end of period, gives the cost of sales. In a manufacturing concern the factory cost of production takes the place of purchases. These items will have already been verified in auditing the Balance Sheet, but nevertheless care should be taken to see that this heading has not been made a dumping ground for charges which would be more properly embraced under the heading of special charges. The composition of the items entering into the cost of sales should be traced in totals into the cost ledgers or accounts.

Gross Profit on Sales. "This is obtained by deducting the cost of sales from the net sales. The ratio of gross profits to net sales should be calculated and compared.

Selling, General and Administrative Expenses. "Under these general headings should be set down the expenses itemized to correspond with the titles of the ledger accounts kept in each division. In checking the totals of each account with the statement for the period under audit, special attention to credits in these accounts should be given to see that none have been made for the sale of capital assets and for other items which should not appear in expense accounts. The percentages of the totals of each division and of the aggregate total to net sales should be calculated for each year for comparison.

Net Profit on Sales. "This is obtained by deducting the aggregate total of the selling, general, and administrative expenses from the gross profit on sales, and shows the net earnings of the concern on its real business. Ratio to sales should be calculated for each year for comparison.

Other Income. "Under this heading is embraced any income that may be derived from sources outside of sales, such as income from investments, interest, discounts, etc. Schedules should be prepared of each item, and the auditor should satisfy himself of their accuracy and of the propriety of including them as income.

Deductions from Income. "Under this heading are grouped such items as interest on bonded debt, interest on notes payable, etc. The same procedure of verification as in the case of other income should be followed.

Net Income—Profit and Loss. "Adding other income to gross income and deducting deductions from income gives the net income or profit and loss for the period, which is the amount that should be carried to the Surplus account.

Surplus Additions and Deductions. "Items of unusual or extraordinary profit which do not belong strictly to the period under audit, or cannot be said to be the legitimate result of the ordinary transactions of the concern, should be entered here and verified with the Surplus account. Similarly, deductions should be treated. Also dividends declared should be entered in the Surplus account and as an item under this caption, inasmuch as it is the usual custom to declare dividends 'from net earnings and surplus.' After adding special credits to and deducting special charges from the net income, we have the total profit and loss for the whole period from all sources which, added to the surplus balance at the beginning of the period, gives us the surplus at the end of the period, which should agree with the surplus as stated on the Balance Sheet.

General. "These instructions cover audits of small or medium sized concerns. In large concerns having, for instance, tens of thousands of accounts or notes receivable, the detail procedure suggested would be impracticable, and internal check should make it unnecessary. In such cases only tests can be made, but the auditor must always be prepared to justify his departure from a complete program by showing that the purposes sought to be accomplished thereby have been adequately effected by his work.

"Any extensive clerical work, such as preparations of lists of notes receivable, etc., should be performed by the client's staff, so as to avoid unnecessary employment of professional staff in merely clerical work and consequent undue expense."

THE PROFIT AND LOSS STATEMENT

A Profit and Loss statement should be submitted with the income and expenditures classified under appropriate captions, and, if possible, this statement should show the operations in comparative form. If comparative figures for several years are submitted, the accountant must satisfy himself that the figures for all periods are prepared on the same basis. Instances are frequent where concerns make a liberal provision for depreciation, etc., in prosperous years, and reduce, or even eliminate, all depreciation in years during which business is poor and profits small. Occasionally, a basis of inventory valuation is adopted differing materially from the basis used the year before, and some concerns show a tendency to charge to capital during lean years, items of a nature which are absorbed in operating expenses during prosperous years.

Since the Income and Excess Profits Tax Laws became effective, business men are liable to set up excessive depreciation and to charge to operating expense, expenditures which should have been capitalized. An instance recently came to the writer's attention wherein a concern charged to operating expenses, extensive improvements on grounds surrounding the plant, such as building of fences, driveways, sidewalks, parks, etc., costing thousands of dollars, not a cent having been capitalized. When the books of the company were audited by Income Tax inspectors the expenditures were analyzed, those representing improvements that increased the value of the property were charged to capital and not allowed as deductions from income; hence, the company was assessed for additional taxes.

Increases or decreases in the sales should be carefully scrutinized. A recent audit of a manufacturing concern disclosed a substantial increase in sales when compared with the operations of the preceding year, but a thorough investigation revealed the fact that the increase was due entirely to large orders having been received from two new customers. Had this new business not been obtained, the sales for the last year reported on would have shown an actual decrease.

The Profit and Loss statement should be so arranged as to reflect the actual results of the period, and the figures shown thereon should not need any explanation or qualification. The Model Statement of Profit and Loss, shown on page 214 of this Chapter, is a comparative statement for a period of three years. It would be quite impossible to show a form of statement that would fit every business. The form shown is general and at the same time is simple enough to be easily comprehended. It is based on Federal Reserve Board requirements.

In a manufacturing enterprise a special statement of factory operations showing cost of goods manufactured and sold should also be prepared. The cost of sales as arrived at from the statement of factory operations, may be used in arriving at the gross profit on sales in the Profit and Loss statement. A model statement showing cost of goods manufactured and sold is exhibited below.

Material			
Inventory, beginning of period			$xxxxx.xx
Material purchased		$ xxxxx.xx	
Freight and cartage inward		xxxxx.xx	xxxxx.xx
Cost of Accountable Material			xxxxx.xx
Deduct inventory, ending of period			xxxxx.xx
Cost of Material Consumed			xxxxx.xx
Add:			
Labor		xxxxx.xx	
Manufacturing expenses:			
Depreciation on buildings	$ xxxxx.xx		
Depreciation on machinery	xxxxx.xx		
Factory expense	xxxxx.xx		
Fuel	xxxxx.xx		
Insurance, bldgs. and machinery	xxxxx.xx		
Repairs to building	xxxxx.xx		
Repairs to machinery	xxxxx.xx		
Taxes on real estate	xxxxx.xx		
Total manufacturing expenses		xxxxx.xx	xxxxx.xx
Add work in process, beginning of period			xxxxx.xx
			xxxxx.xx
Deduct work in process, ending of period			xxxxx.xx
Cost of Goods Manufactured			xxxxx.xx
Add inventory finished goods, beginning of period			xxxxx.xx
			xxxxx.xx
Deduct inventory finished goods, ending of period			xxxxx.xx
Cost of Sales			$xxxxx.xx

(Model Statement of Cost of Goods Manufactured and Sold)

	Year ending—		
	19—	19—	19—
Gross sales	$xxxx.xx	$xxxx.xx	$xxxx.xx
Less outward freight, allowances and returns	xxxx.xx	xxxx.xx	xxxx.xx
Net sales	xxxx.xx	xxxx.xx	xxxx.xx
Inventory beginning of year	xxxx.xx	xxxx.xx	xxxx.xx
Purchases, net	xxxx.xx	xxxx.xx	xxxx.xx
	xxxx.xx	xxxx.xx	xxxx.xx
Less inventory end of year	xxxx.xx	xxxx.xx	xxxx.xx
Cost of sales	xxxx.xx	xxxx.xx	xxxx.xx
Gross profit on sales	xxxx.xx	xxxx.xx	xxxx.xx
Selling expenses (itemized to correspond with ledger accounts kept)	xxxx.xx	xxxx.xx	xxxx.xx
Total selling expense	xxxx.xx	xxxx.xx	xxxx.xx
General expenses (itemized to correspond with ledger accounts kept)	xxxx.xx	xxxx.xx	xxxx.xx
Total general expense	xxxx.xx	xxxx.xx	xxxx.xx
Administrative expenses (itemized to correspond with ledger accounts kept)	xxxx.xx	xxxx xx	xxxx.xx
Total administrative expense	xxxx.xx	xxxx.xx	xxxx.xx
Total expenses	xxxx.xx	xxxx.xx	xxxx.xx
Net profit on sales	xxxx.xx	xxxx.xx	xxxx.xx
Other income:			
Income from investments	xxxx.xx	xxxx.xx	xxxx.xx
Interest on notes receivable, etc.	xxxx.xx	xxxx.xx	xxxx.xx
Gross income	xxxx.xx	xxxx.xx	xxxx.xx
Deductions from income:			
Interest on bonded debt	xxxx.xx	xxxx.xx	xxxx.xx
Interest on notes payable	xxxx.xx	xxxx.xx	xxxx.xx
Total deductions	xxxx.xx	xxxx.xx	xxxx.xx
Net income—profit and loss	xxxx.xx	xxxx.xx	xxxx.xx
Add special credits to profit and loss	xxxx.xx	xxxx.xx	xxxx.xx
Deduct special charges to profit and loss	xxxx.xx	xxxx.xx	xxxx.xx
Profit and loss for period	xxxx.xx	xxxx.xx	xxxx.xx
Surplus beginning of period	xxxx.xx	xxxx.xx	xxxx.xx
	xxxx xx	xxxx.xx	xxxx.xx
Dividends paid	xxxx.xx	xxxx.xx	zxxx.xx
Surplus ending of period	$xxxx xx	$xxxx.xx	$xxxx.xx

(Model Comparative Statement of Profit and Loss)

HOW TO END AN AUDIT

Completing an Audit. When an audit has been completed, the juniors should hand their working papers to the senior. The senior then assembles them and, before leaving the office of the client, he should check over the Trial Balance together with the various schedules, analyses and summaries supporting it, and prepare in journal form any correcting or adjusting entries that may be necessary. The reason for doing this work immediately and before leaving the place where the work has been carried on, is that if anything should develop which requires attention, access to the books is still possible. It is quite embarrassing to discover, perhaps several days after an audit has been completed, that certain information is needed and it is impractical to return to the office of the client. Satisfactory results in such cases often cannot be obtained by correspondence.

Correcting Entries. Journal entries should be made, together with full explanations, for all errors, whether mechanical or in principle, that have been discovered during the course of an audit. These errors will be shown by the working papers prepared by the persons engaged on an audit. A separate entry should be made for each error found. Usually, after discussing the matter of errors with the client, the bookkeepers will be instructed to make similar correcting entries on the books of account. If this is done the books will show the same results as the statements prepared by the auditor. If, for any reason, the books of the client are not corrected, the auditor should proceed with his working papers in the same manner as outlined, for his statements must show actual, financial conditions.

Adjusting Entries. There are certain facts which may not appear in the accounts at the close of the fiscal period and in order that the books may show true conditions on that date adjusting entries are required. Entries must be made for accrued assets, accrued liabilities, deferred charges to operation, deferred credits, depreciation, reserves, inventories, etc.

The Working Sheet. It is a comparatively simple matter to exhibit the results of an audit in a statement, commonly known as a Working Sheet. The purpose of the Working Sheet is frequently misunderstood. It is not a statement intended as a substitute for the financial statements, but is a summary of the accounts as they appear in the Trial Balance, adjusting data, and a classification of nominal and real accounts, and is prepared for the purpose of gathering together all the information needed from which an auditor may prepare formal financial statements and a formal report for the client.

The correcting and adjusting entries prepared by the auditor in connection with The Blank Manufacturing Company appear below. Each entry is followed by an appropriate explanation and needs no further comment, with the possible exception of the last entry (No. 8) which relates to the inventories. Some accountants do not set up an adjusting entry for the inventory. They simply enter the ending inventories in the Working Sheet arbitrarily and include them only in the "closing journal entries". The entry shown will be found so simple and easily understood that it will be apparent at once that it is undoubtedly the best method for treating the subject.

THE BLANK MANUFACTURING CO.

CORRECTING JOURNAL ENTRIES

Dec. 31, 1918

(1)		
Salaries of Salesmen	$30.00	
Salaries advanced to Salesmen		$30.00
To correct an error of $30.00 in the footing of each of above accounts.		
(2)		
Machinery	$215.00	
Tools and Implements		$215.00
To correct an item of $215.00 charged to Tools and Implements which should have been charged to Machinery as it represented the purchase of a new machine, July 1, 1918.		
(3)		
Surplus	$22,500.00	
Dividend		$22,500.00
To adjust account with Dividend authorized, July 1, 1918, but not charged to Surplus.		

ADJUSTING JOURNAL ENTRIES

Dec. 31, 1918

(1)		
Factory Pay Roll, Labor	$2,875.00	
Surplus (Bond Interest Accrued)	2,315.07	
Accrued Liabilities		$5,190.07
To set up on the books the Accrued Liabilities as follows: (a) Factory pay roll accrued but not paid $2,875.00 (b) Accrued interest on first mortgage bonds $100,000.00 at 5%, July 15, 1918, to Dec. 31, 1918 .... $2,315.07 This is charged to Surplus for the reason that no accrued interest on bonds was calculated at the end of the previous fiscal period, hence the present period should only be charged with bond interest amounting to $5,000.00. The Surplus account must be adjusted because of failure to charge Bond Interest account for accrued interest at end of the previous period.		

(2)			
Deferred Charges to Operations		$13,031.00	
Insurance			$ 456.00
Advertising			12,575.00
To set up Deferred Charges to Operations as follows:			
(a) Insurance Unexpired	$456.00		
(b) Advertising $25,150.00 to be charged off over period of two years, one half deferred	$12,575.00		
(3)			
Accrued Assets		$1,131.17	
Interest and Discount			$1,131.17
To set up Accrued Assets:			
(a) Interest accrued on investment of surplus	$124.59		
(b) Interest accrued on Sinking Fund.	875.34		
(c) Interest accrued on Notes Receivable	131.24		
(4)			
Depreciation		$11,522.95	
Res. for Dep'n. on Buildings, 2½%			$3,750.00
Res. for Dep'n. on Machinery, 6%			6,012.90
Res. for Dep'n. on Horses and Wagons, 10%			1,500.00
Office Furniture			260.05
To set up proper amount of depreciation on fixed assets.			
Note—Office Furniture is credited direct for amount of depreciation, no reserve being set up.			
(5)			
Organization Expense Charged Off		$735.00	
Unapportioned Organization Expense			$735.00
To charge off 10% of Organization Expense.			
(6)			
Bond Discount Charged Off		$300.00	
Bond Discount Unamortized			$300.00
To charge off 5% of Bond Discount.			
(7)			
Loss on Doubtful Notes		$ 258.12	
Loss on Bad Debts		1,694.43	
Reserve for Doubtful Notes			$ 258.12
Reserve for Bad Debts			1,694.43
To set up reserves for estimated loss of 2% on Notes and Accounts Receivable.			
(8)			
Inventory, Finished Stock—new account.		$80,000.00	
Inventory, Materials and Stock in Process—new account		59,875.00	
Inventory, Finished Stock—old account.			$80,000.00
Inventory, Raw Material—old account.			59,875.00
To set up Inventories as of Dec. 31, 1918.			

The Working Sheet on the following pages shows the Trial Balance, the posting of the preceding correcting and adjusting entries, and a proper classification of the nominal and real accounts as prepared by E. R. Stockman, senior accountant, from his working papers and those of the juniors, J. I. King and C. E. Shaw, his assistants.

THE BLANK MANUFACTURING CO.

Working Sheet, December 31, 1918.

Accounts	Trial Balance		Adjustments		Nominal Accounts		Real Accounts	
	Dr.	Cr.	Dr.	Cr.	Losses	Profits	Assets	Liabilities
Cash	20,162.00						20,162.00	
Cash Dep. for Div. No. 9	2,050.00						2,050.00	
Cash Dep. for Bond Int.	2,500.00						2,500.00	
Land	100,000.00						100,000.00	
Buildings	150.000.00						150,000.00	
Machinery	100,000.00		215.00				100,215.00	
Tools and Implements	20,215.00			215.00			20,000.00	
Horses, Wagons and Harness	15,000.00						15,000.00	
Office Furniture	2,600.50			260.05			2,340.45	
Notes Receivable	12,906.00						12,906 00	
Accounts Receivable	84,721.50	3,034.50					84,721.50	3,034.50
Sinking Fund	15,000.00						15,000.00	
Investment of Surplus	10,000.00						10,000.00	
Salary Adv. to Salesmen	980.00			30.00			950 00	
Unap. Organization Exp.	7,350.00			735.00			6,615.00	
Bond Dis. Unamortized	6,000.00			300 00			5,700.00	
Div. No. 9, 5%, Author. 7-1-18	22,500.00			22,500.00				
Good Will	75,000.00						75,000.00	
Unsubscribed Stock	50,000.00						50,000.00	
Notes Payable		21,000.00						21,000.00
1st Mortgage, 5%, 20-yr. Bonds		100,000.00						100,000.00
Accounts Payable		51,780.50						51,780.50
Due to Officers and Clerks		7,681 50						7,681.50
Res. for Bond Int. Coupons Due		2,500.00						2,500 00
Div. No. 9, Vouchers Out		2,050.00						2,050.00
Res. for Bad Debts, $970 written off		56.00		1,694.43				1,750 43
Res. for Dep. on Bldgs, 2½%		2,500 00		3,750.00				6,250.00
Res. for Dep. on Mach., 6%		9,000.00		6,012.90				15,012.90
Res. for Dep. on Horses and Wagons, 10%		1,500.00		1,500.00				3,000.00

Capital Stock, (5000 Sh. at $100)		500,000.00						500,000.00
Sinking Fund Reserve		15,000.00						15,000.00
Sales Less Returns & Allowances		625,275.00				625,275.00		
Rent of Part Bus. Premises		250.00				250.00		
Inv. 12-31-17, Raw Material	37,310.50			59,875.00	37,310.50	59,875.00		
Inv. 12-31-17, Fin. Stock	15,000.00		80,000.00	80,000.00	15,000.00	80,000.00	80,000.00	
Purchases	195,000.00				195,000.00			
Factory Pay Roll, Labor	300,200.00		2,875.00		303,075.00			
In-Freight and Cartage	2,831.00				2,831.00			
Office Salaries and Clerical Force	37,560.00				37,560.00			
Salaries of Salesmen	30,220.00		30.00		30,250.00			
Advertising	25,150.00			12,575.00	12,575.00			
Taxes Paid	2,010.00				2,010.00			
Insurance	1,300.00			456.00	844.00			
Bond Interest	5,000.00				5,000.00			
Interest and Discount	3,250.00			1,131.17	2,118.83			
Stable Expense	2,000.00				2,000.00			
Office and Other Expense	12,875.00				12,875.00			
Maintenance and Repairs	13,471.00				13,471.00			
Surplus (12-31-17)		38,535.00	2,315.07					
			22,500.00					13,719.93
Accrued Assets			1,131.17				1,131.17	
Accrued Liabilities				5,190.07				5,190.07
Deferred Charges to Operations			13,031.00				13,031.00	
Depreciation			11,522.95		11,522.95			
Org. Exp. Charged Off			735.00		735.00			
Bond Dis. Charged Off			300.00		300.00			
Loss on Doubtful Notes			258.12		258.12			
Loss on Bad Debts			1,694.43		1,694.43			
Res. for Doubtful Notes				258.12				258.12
Material and Stock in Process (12-31-18)			59,875.00				59,875.00	
	1,380,162.50	1,380,162.50	196,482.74	196,482.74	686,430.83	765,400.00	827,197.12	748,227.95
Net Profit for Period					78,969.17			78,969.17
					765,400.00	765,400.00	827,197.12	827,197.12

A. THEORY QUESTIONS

1. Would you advise showing profits for prospectus purposes before or after deducting war profits and income taxes? State your reasons briefly. Inst. Ex. 1919.

2. (a) What items do you consider should be charged or credited direct to surplus?

(b) Would you regularly make small adjustments of subsequently discovered errors through this account?

(c) Is the balance at credit of surplus ever in any circumstances a liability, and, if so, to whom? Inst. Ex. 1918.

3. What would you consider satisfactory evidence of the correctness and propriety of expenditures of the following classes:

Wages paid,
Land purchased,
Commission paid to bankers for sale of bonds,
Salary of president,
Expenses of president,
Pensions paid to ex-employes,
Directors' remuneration? Inst. Ex. 1918.

4. There is a confusion in the minds of many people between statements of "revenue and expense" on the one hand and of "receipts and payments" on the other hand. Discuss the distinctive features of such statements showing wherein they differ. Inst. Ex. 1918.

B. ACCOUNTING PROBLEMS

1. Write a reply to the following letter and prepare a Balance Sheet as requested therein:

Dear Sir:

Our bank has asked us for a statement for credit purposes. Will you please prepare one for us?

Our plants stand at their cost price, which is $60,400. We have set up a reserve for a depreciation of $10,200. There is a mortgage for $20,000 on the plant and interest on the mortgage is at 6 per cent and is paid up to 3 months ago. We hold $10,000 of notes receivable and have discounted $25,000 of notes with the bank. Our accounts receivable, which we consider good, amount to $18,000, including $3,000 due from one of our employees on personal account. Our trade accounts receivable are subject to 5 per cent discount if paid at due date, and only $1,000 is now past due. Our accounts in suspense amount to $4,000. I believe these are 50 per cent good. We have ordered a new machine to cost $6,000, but it has not yet been delivered. We have endorsed a note for $6,000 for our friends, the A. B. Co., but I am confident they will take care of it when it is due. Our accounts payable amount to $4,200. Our insurance amounts to $400 a year and has six months to run. We have a note at the bank for $5,000, interest paid to date. We own 50 shares of stock in the company from which we buy raw material. They cost us $2,800 and are surely worth it, though we might have some difficulty in selling them in a hurry. Our inventory is taken at a low selling price, which is 10 per cent more than it cost us. The amount is $17,600. In addition we have a special contract for one of our customers. The contract price is $25,000. We have spent $12,000 on it and expect to have to spend $4,000 more, and we have received $10,000 on account. Our cash in bank is $4,800 and cash in hand $200.

I have told you all the facts I think you need. Perhaps some are not required, but I want to give the bankers all the information they ought to have in the way they expect to get it.

I do not, of course, expect you to accept any responsibility for the figures in the statement, but simply to prepare the statement in the best form you can from this letter. If you have any suggestions as to how I can better meet the bank's requirements let me have them.

(Signed) H. A. SMITH.

Inst. Ex. 1917.

2. You are asked to audit the books of the Michigan Manufacturing Company with a view to ascertaining their true financial position at the close of the year ending Dec. 31, 1918. The following Trial Balance is submitted:

TRIAL BALANCE, DEC. 31, 1918

Cash on Hand and in Bank	$ 430.15	
Notes Receivable	7,907.62	
Customers' Accounts	20,797.80	
Real Estate and Buildings	35,333.83	
Machinery and Equipment	12,344.88	
Horses, Wagons, etc	1,265.40	
Power Machinery Co	727.77	
Manufacturing Materials	133,848.53	
Misc. Factory Supplies	1,631.09	
Productive Labor	63,842.23	
Freight, Express and Cartage "In"	1,734.70	
Stable Expense	1,694.11	
Misc. Non-Productive Labor	1,993.50	
Fuel	5,554.82	
Insurance	3,872.32	
Repairs to Machinery	507.73	
Water Tax	140.53	
Advertising	378.58	
Discount allowed to Customers	3,362.19	
Postage	264.42	
Salaries	6,170.00	
Stationery and Office Supplies	296.02	
Miscellaneous Main Office Expense	241.08	
Interest Paid	3,386.80	
Accrued Pay Rolls		$ 487.66
Notes Payable		22,344.81
Accounts Payable		5,512.34
Sundry Creditors		2,511.89
Reserve for Bad Debts		1,059.51
Capital Stock		85,000.00
Sales		187,540.38
Discounts Earned on Purchases		2,081.59
Interest Earned		463.17
Miscellaneous Earnings		724.75
	$307,726.10	$307,726.10

During the course of your audit you find that the inventory of manufacturing material at the beginning of the year was $27,214.41, and at the close of the year $51,358.58. At the close of the year there was also factory supplies on hand to the amount of $200.00, as well as fuel $2,188.40, and horse feed $14.22. You find that the unexpired insurance premiums amounted to $1,720.18; that the accrued interest on notes payable amounted to $134.83 and accrued taxes to $376.75. An analysis of the customers' accounts disclosed the fact that $9,128.11 was very doubtful of collection. The item of $727.77 to Power Machinery Co. represents an advance payment made on machinery which has been purchased, but not yet completely installed and not included in Machinery account. You find in the account for Horses and Wagons a charge for $75.00 for difference paid on an exchange of horses, the new horse being presumably of the same value at which the old horse originally entered. Prepare Balance Sheet, Manufacturing Statement and Profit and Loss statement providing for depreciation of 10% on Machinery and Equipment.

C. P. A. Mich.

(**Note.** You are also required to prepare the adjusting journal entries and a Working Sheet similar in form to the one illustrated on pages 220 and 221 of this chapter. It is important that your entire solution be prepared in standard form, neatly exhibited and absolutely accurate. After you have your working papers ready to submit, be sure to check each item over again, using every precaution to avoid any possible errors or misstatements. Let your statements be in such form as you would prepare them if they were to be submitted to a client.)

PRACTICE DATA

(Continued from Chapter Thirteen)

Transaction No. 6. Upon demand, the following subscribers to the capital stock paid their subscriptions in full in cash and stock certificates were issued:

A. B. Opfer	$300,000.00
H. W. Henry	100,000.00
Maude E. Barnes	300,000.00
Ruth E. Forry	350,000.00
E. W. Atkinson	550,000.00

Transaction No. 7. The following purchases for cash were made:

Machinery	$300,000.00
Land	500,000.00
Buildings	250,000.00
Merchandise	500,000.00

Transaction No. 8. All of the preceding transactions really relate to the organization of the company and were completed before the company was ready to begin operations. Open accounts on ledger paper, allowing eight lines for each account and post your journal entries. Take a Trial Balance as of December 31, 1919.

Transaction No. 9. At the close of business December 31, 1920, it was decided to employ a Certified Public Accountant to make an audit of the books of the company. Assume that you were directed to complete the audit and prepare the report. The business has been in operation for a period of one year. Preliminary investigation showed that the system of accounts had been poorly devised and that no satisfactory internal check had been maintained; therefore, a detailed audit was recommended and authorized. During the course of the audit it became evident that the book entries could not be relied on and many vouchers were missing. There seemed to be no evidence of embezzlement, but the errors seemed to be due to a lack of knowledge of the ordinary principles of bookkeeping on the part of the bookkeeper. It seemed no effort had been made to keep the books in balance, the bookkeeper apparently having been satisfied in keeping only his cash in balance. Aggregate entries were found to have affected the respective accounts during the current year as follows:

Purchases	$306,000.00
Pay Rolls	212,000.00
Factory Expenses	18,000.00
Freight and Express (Inbound)	1,000.00
Administrative Expenses	27,000.00
Selling Expenses	8,000.00
Interest on Notes Payable	22,000.00
Miscellaneous Interest Expense	500.00
Interest Received	1,000.00
Sales	942,000.00
Returns and Allowances (Sales)	4,000.00
Bad Debts and Special Allowances	32,000.00
Freight on Goods Sold	2,000.00
Machinery, Tools and Equipment(Add.)	37,530.00
Office Furniture and Fixtures (Additions)	800.00
Machinery, Tools and Equipment Sold	19,000.00
Patents (Additions)	10,000.00

Analysis of the Machinery account showed that the cost price of the machinery, tools and equipment sold was $20,000.00, there having been a loss of $1,000.00 incurred through the sale. Post above aggregate entries to the proper accounts, opening new accounts when necessary. Journal entries are not required.

Transaction No. 10. After analyzing the ledger accounts, the following net changes were found to have occurred in the respective accounts during the course of the year:

	Debit	Credit
Cash	$134,870.00	
Notes Receivable	7,000.00	
Accounts Receivable	35,000.00	
Prepaid Administrative Expenses	1,000.00	
Notes Payable, Banks		$7,700.00
Notes Payable, Trade	57,000.00	
Accounts Payable	67,000.00	
Accrued Pay Roll		8,000.00
Notes Receivable Discounted		5,000.00

Accrued Salaries is the same as at the end of the previous year. Post to the proper accounts. Journal entries are not required.

Transaction No. 11. It was found that the entire interest on the First and Second Mortgage Bonds, amounting to $29,880.00, has been added to machinery and tools. The interest on the Debenture Bonds, amounting to $7,650.00, had been charged to administrative expense. All bonds were issued December 31, 1919, the interest payable semiannually on June 30 and December 31.

Formulate correcting entries in journal form and post to the proper accounts. Take a Trial Balance.

Transaction No. 12. Specific reserves are to be set up as follows:

Reserve for depreciation on buildings	2½%
Reserve for depreciation on machinery, tools and equipment	10%
Depreciation on patents	6%
Depreciation on office furniture and fixtures	10%
Reserve for doubtful accounts	2½%

Depreciation is to be calculated on the cost price of fixed assets on hand at the beginning of the current year. The reserve for doubtful accounts is estimated to amount to 2½% of the total accounts receivable as at the end of the current year. (Drop the cents. Use the nearest dollar.)

The inventory shows merchandise on hand amounting to $650,000.00.

Formulate adjusting journal entries.

Chapter Fifteen

THE REPORT

In the previous chapter there was illustrated the Working Sheet prepared by the senior in charge of the audit of The Blank Manufacturing Company.

After the senior in charge has prepared a Working Sheet, supported by the necessary schedules from the working papers of the various persons employed in connection with an audit, and has them arranged in proper form, they are usually turned over to someone in the office, whose duty it is to prepare what is known as a Report. This Report may be divided into three parts—the statements, the comments and the certificate.

The Statements. There are two classes of statements—exhibits and schedules. The principal statements, such as the Balance Sheet and the Profit and Loss statement are known as exhibits, while the supporting statements, such as a Statement of Factory Operations, Analysis of General Expenses, Statement of Investments, etc., are known as schedules.

It is needless to say that every possible precaution must be used to insure absolute accuracy in the preparation of the statements. All the information should be obtainable from the Working Sheet and working papers which accompany it. The calculations and copying must be carefully verified by someone in authority. It is customary for the managing senior, a partner of the firm, or an officer of the company to pass upon the entire report before submitting it to the client.

In preparing the report, the auditor should have in mind the use that will be made of the information it will contain, for he may occasionally be able to make his report cover more fully some special points that will be of particular interest to the client. For instance, the prospective purchaser of stock would be primarily interested in the earnings or dividends of the corporation and of its value as a going concern. The prospective purchaser of bonds would be principally interested in the value of the property mortgaged and the ability of the company to maintain the interest payable during the life of the bonds and to retire them at maturity. The banker, while interested incidentally in the earning capacity of the concern, would be primarily desirous of knowing the probable ability of the concern to repay the loan at maturity. The stockholder's chief interest is usually in the earn-

ing capacity of the corporation and of the conduct of the business in the past by the directorate chosen by the stockholders.

The Comments. It is customary for the auditor to submit comments in connection with the statements prepared for the client. These comments are made to explain any unusual items appearing in the financial statement, to describe his investigations into certain matters, to present what criticisms are considered necessary, to make suggestions that may be of value to the client, and, if so requested, to make what recommendations he considers advisable.

Properly prepared comments may be of great value to a client. They may be constructive and may lead to vast improvements in the accounting records and the means of keeping the records. If a proper method of internal check has not been maintained, he may make suggestions as to how to bring about a satisfactory system of internal checking. This is undoubtedly constructive. Wildman says, concerning the wording of the report that, "Good construction advocates the use of simple words, short sentences and nontechnical expressions as far as possible. By so doing someone may be bored, but it is much better to use language which the ordinary man understands rather than to attempt to impress readers with literary style. It is not necessary to indulge in literary style. All that is required is to express such thoughts as a person may have in connection with a technical subject in a clear, concise way which the layman will understand. The professional auditor is not expected to be a literary expert. He is expected to have an accounting sense and to understand accounting, and to be able to use English sufficiently well to express clearly what he has to say on the subject."

The Certificate. When an auditor is employed by a business man, he is expected to submit proper statements of financial condition in standard form properly certified. The object of obtaining a certificate from the auditor is to secure from an unbiased person, one who is skilled in professional accounting, an opinion as to the accuracy of the accounts and statements which exhibit actual financial conditions.

Federal Reserve requirements specify that,

"The Balance Sheet and certificate should be connected with the accounts in such a way as to ensure that they shall be used only conjointly. This rule applies also to any report or memorandum containing any reservations as to the auditor's responsibility; any qualification as to the accounts, or any reference to facts materially affecting the financial position of the concern.

"The certificate should be as short and concise as possible, consistent with a correct statement of the facts, and if qualifications are necessary the auditor must state them in a clear and concise manner.

"If the auditor is satisfied that his audit has been complete and conforms to the general instructions of the Federal Reserve Board, and that the Balance Sheet and Profit and Loss statement are correct, or that any minor qualifications are fully covered by the footnotes on the Balance Sheet, the following form is proper:

> "I have audited the accounts of Blank & Co. for the period from............ to .... and I certify that the above Balance Sheet and statement of Profit and Loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board, and in my opinion set forth the financial condition of the firm at .... and the results of its operations for the period.
>
> (Signed),
>
> A. B. C."

The Auditor's Responsibility. Opinions vary as to the extent of an auditor's guarantee, and as to his legal responsibility in case of an error being subsequently discovered in the statements which he has certified. This responsibility was discussed briefly on page 9 of Chapter One. Concerning the extent of an auditor's guarantee, what Lawrence R. Dicksee, F. C. A., of the firm of Price & Dicksee, says in his manual on "Auditing" is so appropriate that we can do no better than to quote from him:

"Unfortunately, this is a matter upon which the profession are by no means agreed; while, on the other hand, the cases that have been decided by the courts are so few, and the questions at issue actually so narrow, that sufficient precedents are not available to definitely settle the matter. At the same time, it is well to remember that, however desirable it may be to know exactly the bare extent of the legal responsibility, the real professional responsibility to clients ought always to be the ideal, and, further, an auditor will be the worst of friends to his profession if he studiously exerts himself to narrow the responsibilities, and so to dwarf the importance of his position.

"The responsibility involved in certifying a Balance Sheet to be absolutely correct is so great, so limitless, that many have preferred to discard all claim to such a position of certainty, and prefer merely to certify a Balance Sheet as being 'in accordance with the books.' Auditors, however, will hardly require to be reminded that an investigation which had been limited to the

comparison of the Balance Sheet with the books would be, for every purpose, absolutely valueless. So obvious is this conclusion that no professional auditor would ever think of confining his investigation to this particular point, yet many experienced auditors appear to be afraid to make any certification as to the result of such further investigation as they know to be essential. Such a state of affairs is unsatisfactory to the client and discreditable to the auditor. Again, it is a very open question as to whether so unsatisfactory a certificate would ever have the effect of limiting the legal responsibility of the auditor to the exact points certified. It is, at least, possible that the court would view the matter from a broader aspect, and consider that the man who had accepted the position of auditor, to say nothing of the fees incident thereto, had also undertaken the responsibilities of that position, and that it would be disposed to form its own opinion as to the real extent of such responsibilities.

"It would appear, therefore, that the auditor who does not consider his investigation has been sufficiently searching escapes no liability by issuing a carefully modified certificate; and, indeed, such a course is decidedly unmanly, somewhat dishonest and exceedingly childish. These are strong words, but not stronger than the circumstances appear to require.

"When addressing a meeting of the Institute of Chartered Accountants, Mr. Frederick Whinney, F. C. A., expressed himself as follows: 'I know perfectly well that a proper auditor must go further (than comparing the published accounts with the books) and see that books themselves do correspond,' and this view appears to be endorsed by legal decisions. As to how far it is possible for this standard to be carried into practice, there is perhaps some room for the elasticity of individual opinion, but the general statement is absolutely unassailable.

"The chief evidence is, of course, the books (and it may be remarked, incidently, that it is clearly the auditor's duty to see that the accounts he certified, in addition to being correct, are in accordance with the books), but the books must not be considered the sole source of evidence; the fact that a statement appears in the books is prima facie evidence only, and must be verified, not only by internal cross-examination, but also by reliable and independent evidence.

"The result of such an examination will be that the auditor has proved to himself that certain statements represent absolutely indisputable facts, and that certain other statements in his opinion appear to represent facts. Beyond this—not being omniscient—he can not go, and should never attempt to go. Let him therefore certify that he has thoroughly examined the accounts, that they are in accordance with the books, and are, in his opinion, correctly stated; he will then be occupying a logical, manly position—far more in keeping with the dignity of his profession than that afforded by the most skillful of word juggling."

OFFICE:
309 W. THIRD ST.
CINCINNATI, O.

EXAMINATIONS
INVESTIGATIONS

J. F. Sherwood

**CERTIFIED PUBLIC ACCOUNTANT
AND AUDITOR**

Telephone Main 2647

AUDITS
REPORTS
SYSTEMS

Cincinnati, Ohio, March 1, 1919.

THE BLANK MANUFACTURING CO.

CERTIFICATE

Mr. C. H. Becker,
Chairman, Board of Directors,
The Blank Manufacturing Co.,
Indianapolis, Ind.

Dear Sir:

In accordance with our engagement, I have made an audit of the accounts of The Blank Manufacturing Company for the year ended December 31, 1918, and herewith submit my report which includes the following:

Exhibit "A" —Balance Sheet, December 31, 1918.

Exhibit "B" —Statement of Profit and Loss for the year ended, December 31, 1918.

Schedule "B-1"—Statement of Cost of Goods Manufactured and Sold for the year ended, December 31, 1918.

Comments. (Two pages.)

I HEREBY CERTIFY that the attached statements have been prepared in accordance with the plans suggested and advised by the Federal Reserve Board and, in my opinion, set forth the true financial condition of the business as of December 31, 1918, and the results of operations for the year ended December 31, 1918.

Respectfully submitted,

(Signed) J. F. SHERWOOD
C. P. A.

THE BLANK MANUFACTURING CO.

Balance Sheet—Dec. 31, 1918

ASSETS

Cash:			
Cash in Bank..............		$20,162.00	
Cash Dep. for Div. No. 9	$2,050.00		
Less Div. Vouchers Out.	2,050.00		
Cash Dep. for Bond Int....		2,500.00	$22,662.00
Notes and Accounts Receivable:			
Notes Rec. Cus. (Not past due)		10,806.00	
Accts. Rec. Cus. (Not past due)		73,807.80	
Notes Rec. Customers (Past due but considered good)..		600.00	
Accts. Rec. Cus. (Past due).		10,913.70	
		96,127.50	
Less:			
Res. for Dbt. Notes, 2%	258.12		
Res. for Bad Debts, 2%	1,750.43	2,008.55	94,118.95
Inventories, Dec. 31, 1918:			
Mat. and Work in Process..		59,875.00	
Finished Stock.............		80,000.00	139,875.00
Accrued Assets:			
Interest on Notes Receivable		131.24	
Interest on Inv. of Surplus		124.59	
Interest on Sinking Fund....		875.34	1,131.17
Total Quick Assets.......			$257,787.12
Securities:			
Notes Receivable (Gen. Mgr.)		1,500.00	
Investment of Surplus......		10,000.00	
Salaries Adv. to Salesmen..		950.00	12,450.00
TotalCurrent Assets......			$270,237.12
Fixed Assets:			
Land.......		100,000.00	
Buildings.......	150,000.00		
Less Res. for Depr. 2½%	6,250.00	143,750.00	
Machinery...............	100,215.00		
Less Res. for Depr. 6%...	15,012.90	85,202.10	
Tools and Implements......		20.000.00	
Horses, Wagons and Harness	15,000.00		
Less Res. for Depr. 10%..	3.000.00	12,000.00	
Office Furniture............	2,600.50		
Less Depreciation........	260.05	2,340.45	
		363,292.55	
Sinking Fund.......		15,000.00	
Total Fixed Assets.....			$378,292.55
Deferred Charges to Operations:			
Insurance.................		456.00	
Advertising................		12,575.00	
Unapportioned Organ. Exp.		6,615.00	
Bond Discount Unamortized		5,700.00	25,346.00
Total Assets...........			$673.875.67

Exhibit "A"

THE BLANK MANUFACTURING CO.

Balance Sheet—Dec. 31, 1918

LIABILITIES

Notes and Accounts Payable:		
Notes Payable..........................	$21,000.00	
Accounts Payable........	51,780.50	$72,780.50
Special Accounts Payable:		
Due to Officers and Clerks.............	7,681.50	
Customers with Credit Balances........	3,034.50	10,716.00
Accrued Liabilities:		
Factory Pay Roll—Labor..............	2,875.00	
Bond Interest Accrued.................	2,315.07	5,190.07
Total Current Liabilities...........		$88,686.57
Fixed Liabilities:		
First Mortgage 5%, 20-year Bonds......		100,000.00
Reserve Accounts:		
Sinking Fund Reserve.................	15,000.00	
Reserve for Bond Interest..............	2,500.00	17,500.00
		$206,186.57
Net Worth:		
Capital Stock Authorized..............	500,000.00	
Less Unsubscribed Stock......	50,000.00	
	450,000.00	
Surplus..............................	13,719.93	
Undivided Profits (see Exhibit "B")....	78,969.17	
	542,689.10	
Less Book Value of Good Will..........	75,000.00	$467,689.10
Total Liabilities and Net Worth.....		$673,875.67

Exhibit "A"

THE BLANK MANUFACTURING CO.

Statement of Profit and Loss

Year Ended Dec. 31, 1918

Sales (less returns and allowances)		$625,275.00	
Less Cost of Sales (Schedule "B-1")		439,429.40	
Gross Profit on Sales..........			$185,845.60
Operating Expenses:			
Selling Expenses:			
Advertising................	$12,575.00		
Salaries of Salesmen........	30,250.00		
Stable Expense............	2,000.00		
Depr. on Horses, Wagons and Harness............	1,500.00		
Total Selling Expenses........		46,325.00	
General Expenses:			
Office and Other Expenses..	12,875.00		
Office Salaries and Clerical Force..................	37,560.00		
Depr. on Office Furniture..	260.05		
Loss on Doubtful Notes, 2%	258.12		
Loss on Bad Debts, 2%....	1,694.43		
Total General Expenses.......		52,647.60	
Total Expenses............			98,972.60
Net Profit on Sales..........			$86,873.00
Other Income:			
Rent from Part of Business Premises................			250 00
Gross Income................			$87,123.00
Deductions from Income:			
Interest and Discount......		2,118.83	
Bond Interest..............		5,000.00	
Total Deductions..........			7,118.83
Net Operating Income.......			$80,004.17
Special Charges to Profit and Loss:			
Organization Expense Written off..................		735.00	
Bond Discount Amortized...		300.00	
Total Special Deductions....			1,035.00
Profit for Period (To Surplus).			$78,969.17
Surplus, Jan. 1, 1918...........		38,535.00	
Less:			
Dividend, July 1, 1918......	22,500.00		
Bond Interest Adjustment..	2,315.07	24,815.07	13,719.93
Surplus, Dec. 31, 1918.........			$92,689.10

Exhibit "B"

THE BLANK MANUFACTURING CO.

Statement of Cost of Goods Manufactured and Sold

Year Ended Dec. 31, 1918

Material:		
Inventory, Raw Material, 12-31-17......	$37,310.50	
Purchases..........	195,000.00	
In-freight and Cartage.................	2,831.00	
Cost of Material Consumed................	235,141.50	
Labor, Factory Pay Roll...............	303,075.00	
Prime Cost of Material Consumed......		$538,216.50
Manufacturing Expenses:		
Maintenance and Repairs..............	13,471.00	
Depreciation—		
Machinery, 6%....................	6,012.90	
Buildings, 2½%..................	3,750.00	
Taxes............................	2,010.00	
Insurance........................	844.00	
Total Manufacturing Expenses..............		26,087.90
		$564,304.40
Deduct:		
Inventory, Materials and Stock in Process 12-31-18.........................		59,875.00
Cost of Production.....................		$504,429.40
Add:		
Inventory, Finished Stock, 12-31-17......		15,000.00
		$519,429.40
Deduct:		
Inventory, Finished Stock, 12-31-18.....		80,000.00
Cost of Sales (To Exhibit "B")...........		$439,429.40

Schedule "B-1"

THE BLANK MANUFACTURING CO.

Comments on the Audit

For the Year Ended Dec. 31, 1918

1. ACCOUNTS RECEIVABLE

The individual accounts receivable were verified by correspondence. The schedule of the accounts from the customers ledger was checked and it agreed with the controlling account in the general ledger. A fact to be noted, however, is that the total debit balances of customers' accounts amounted to $84,721.50, while there were credit balances amounting to $3,034.50. Instead of using the balance of the controlling account in the Balance Sheet, it was thought best to list the total debit balances among the current assets and to list the total credit balances among the current liabilities.

2. INVENTORIES

The inventories were carefully checked and tested and found to be correct as stated. They were calculated at cost or market price, whichever was the lower. It would have been better had the inventory of "raw material" and "work in process" been separated, but for some unexplainable reason they were combined in one sum. This has no material effect upon the statements at this time. Hereafter, it would be better to state the inventory in three divisions:

(a) Raw Material.
(b) Work in Process.
(c) Finished Goods.

3. FIXED ASSETS

All fixed assets are stated at cost less the depreciation provided for. Reserves for depreciation have been established for all of the fixed assets, except tools and implements, and office furniture, the practice having been to credit the Office Furniture account direct with the amount of depreciation, and to take a physical inventory of tools and implements annually.

4. RATES OF DEPRECIATION

The rates of depreciation are considered approximately correct as stated. It is to be noted, however, that in the case of machinery, no provision has been made for obsolescence. Inasmuch as there is a likelihood of obsolescence with regard to the machines in use before they have depreciated to scrap value, it might be well to take cognizance of it. The rate of depreciation is not sufficiently high to provide for this obsolescence.

5. AMORTIZATION OF BOND DISCOUNTS

The method of amortizing the bond discounts which were set up at the time of the sale of the bonds is not scientifically correct but is reasonably accurate, and it is doubtful whether there would be any real value in changing the established procedure at this time.

6. BOND INTEREST

At the end of the previous period, December 31, 1917, there should have been charged to Bond Interest the amount of the accrued interest from July 15 to December 31, 1917. This was not done, hence it was necessary to adjust the Surplus account because we could not charge more than $5,000.00 to the Bond Interest account for the year 1918, as the total interest on the bonds for the year would only amount to this sum.

7. INCOME AND EXCESS PROFIT TAXES

It would be unwise to distribute the net profit for the year before provision has been made for Income and Excess-Profits Taxes. At least, a reserve for the estimated amount of such taxes should be set up before any action is taken regarding the distribution of profits.

8. SINKING FUND APPROPRIATION

There is a provision to the effect that $15.000.00 must be appropriated for the sinking fund before profits are distributed.

9. ADVERTISING

This account represents expenditures in connection with the publication of a catalog and miscellaneous advertising matter, and, inasmuch as a physical inventory shows that a large part of this material is still on hand and unused, it was thought best to defer one-half of the cost to the next fiscal period. This advertising matter is to be used over a period of two years, and, inasmuch as both years will benefit from it equally, we have only charged off one-half of the cost of advertising to current expenses.

10. ORGANIZATION EXPENSES

Investigation showed that there were organization expenses amounting to $7,350.00 that had not been charged off. The policy of the company has been to charge off 10 per cent of the balance of this account annually. While it might be more conservative to charge this off over a shorter period of time, yet in the face of the fact that there is no doubt but that the first ten years will benefit from these expenditures, there can be no harm in apportioning them over this period of time.

11. GOOD WILL

At the time the corporation was formed the business of a partnership was in part taken over. The corporation was forced to pay a sum of $75,000.00 on account of the good will of the partners. This valuation was based largely upon the value of a trade name and other intangible assets. Inasmuch as the account, therefore, represents an actual investment, it would seem that there can be no criticism in permitting it to stand on the books of account. While it might be conservative practice to write off the account proportionately over a period of years, yet this is a financial matter to be decided by the management. It is to be noted that instead of classifying it among the assets in the Balance Sheet, we have deducted it from the net worth of the concern.

Since we have been asked to express our opinion in the matter, we believe that it would be wise to install a Cost Accounting system which should connect with the general accounting records, and would enable the management to determine costs accurately and thereby determine selling prices in an intelligent manner instead of a more or less arbitrary manner as at present. The material and stock records, if kept properly, would also enable the chief accountant to furnish monthly comparative statistics and interim financial statements that would prove of great benefit to the executives in making their plans, and would enable them to know just where they stand at all times.

In conclusion, we are desirous of expressing our appreciation of the cooperation rendered us during the period of the audit, and we also desire to state that the books of account have been kept accurately and neatly, which, of course, aided materially in completing the audit promptly.

Respectfully,
(Signed) J. F. SHERWOOD,
C. P. A.

A. THEORY QUESTIONS

1. What is meant by a qualified certificate? Give an illustration of a case in which a qualified certificate might properly be given and draft a qualification applicable to that case.
Inst. Ex. 1917.

2. What are the essentials of an audit certificate in an audit for credit purposes? Inst. Ex. 1917.

3. Draft a form of audit certificate to accompany a Balance Sheet which is to be published in the annual report of a corporation. Inst. Ex. 1918.

4. Draw up an outline of a report on your audit of the accounts of a corporation that has recently erected a large apartment house. Assume your instructions covered the period of erection and at least one year of operation. Inst. Ex. 1918.

5. Give your opinion of the following form of certificate to a Balance Sheet:

> "I have examined the above Balance Sheet and certify that it is in accordance with the books of the Company."
>
> (Signed) CHARLES E. WILSON

C. P. A. Ill.

6. If employed by the officers of a corporation to make an audit, would you make any difference in your plans and in your report if you knew whether the audit was to be presented to a prospective purchaser of the stock, to a prospective purchaser of bonds, to the bank as a basis for the purpose of securing a loan, or to the stockholders at their regular annual meeting? If so, state the differences. C. P. A. Mich.

B. ACCOUNTING PROBLEMS

1. From the following accounts appearing on the Trial Balance, prepare without using figures, statements which you consider best calculated to set forth the operations of the year and the financial position at December 31, 1916, assuming that you are preparing these statements on behalf of a bank which desires paper available for rediscount with the federal reserve bank.

Accounts payable
Accounts receivable
Advertising
Buildings
Capital stock
Capital stock unsubscribed
Cash on deposit
Commissions paid salesmen
Depreciation buildings 1916
Depreciation machinery 1916
Discount allowed on sales
Discount rec'd. on purchases
Doubtful accounts receivable
Factory expense
Finished goods inv. 12-31-15
Freight and cartage inward
Freight and cartage outward
Fuel
Good will
Insurance bldgs. and mach.

Insurance finished goods
Insurance unexpired buildings and machinery
Insurance unexpired finished goods
Int. accrued on investments
Int. accrued on mortgage pay.
Interest paid
Interest received
Investments
Labor factory payroll
Land
Machinery
Material inventory 12-31-15
Material purchased
Mortgage on plant
Notes payable
Notes receivable
Office expenses
Office furniture and fixtures
Office payroll
Organization expenses (to be distributed over three years from January 1, 1916)
Payroll factory accrued
Payroll office accrued
Petty cash
Prepaid taxes and real estate
Profit and loss 1915 surplus
Repairs buildings
Repairs machinery
Res. for bad and dbt. accounts
Reserve for depr. buildings
Res. for depr. machinery
Returns and allowances on sales
Salaries general officers
Salaries salesmen
Sales
Salesmen accounts—advances on salaries
Subscriptions and donations
Taxes income U. S.
Taxes real estate
Work in process inv. 12-31-15

The inventories December 31, 1916, not on the books were:

Finished goods
Material work in process

Inst. Ex. 1917.

2. The following is the Balance Sheet of the A. B. Company January 1, 1915:

Cash	$ 52,864.00	Accounts payable	$35,482.00
Accounts receivable	197,425.00	Dividends payable pfd. stock 2-1-15	7,500.00
Inventories:		Dividends payable com. stock 2-1-15	10,000.00
Raw material	84,268.00	Mortgage bonds 20-year 6 %, dated Jan. 1,-15	100,000.00
Finished goods	31,597.00	Premium on bonds	5,000.00
Office furniture and fixtures	7,500.00	Capital stock pfd.	250,000.00
Land	180,000.00	Capital stock com.	500,000.00
Buildings	150,000.00	Res. for bad debts	4,718.00
Machinery	250,000.00	Surplus	40,954.00
	$953,654.00		$953,654.00

The transactions for the year ending January 1, 1916, have been as follows:

Cash received from customers	$793,501.00
Rent received	600.00
There has been purchased	
1,232,000 lbs. raw material at 20 cents per lb.	
Sales have been	823,334.00
Discount and allowances on sales	23,519.00
Bad debts written off	2,143.00
Disbursements have been made for	
Accounts payable	243,356.00
Factory expense	7,489.00
Factory labor	351,426.00
Factory repairs	23,843.00
Office expense	1,927.00
Selling expense	52,914.00
Salaries	58,471.00
Taxes	7,853.00

Inventories January 1, 1916
Raw material 412,595 lbs. having a market value of 22 cents per lb. and finished goods $30,842.00. The land is estimated to be worth $200,000.00.

Semi-annual dividends of 3 per cent on preferred and 2 per cent on common, declared in June and December, payable August 1 and February 1. Reserves for depreciation of buildings 3 per cent; machinery 5 per cent; office fixtures 10 per cent. Bad and doubtful debts reserve should be 2 per cent of accounts receivable.

Prepare Statement of Cost of Goods Manufactured and Sold, Profit and Loss statement, and Balance Sheet as of January 1, 1916. Inst. Ex. 1917.

(Note. Beginning with the Balance Sheet at January 1, 1915, it will be necessary to carry the transactions of the year through working papers or to set up skeleton ledger accounts in order to obtain the balances of the accounts which form the basis of the statements at January 1, 1916.)

PRACTICE DATA

(Continued from Chapter Fourteen)

Transaction No. 13. You have now completed your audit of the books of the General Manufacturing Company, but you should prepare a Working Sheet similar in form to the one illustrated on pages 216 and 217. This should be done in the office of the client because it is frequently nesessary to secure additional information. If one were to prepare the Working Sheet in his own office, which might be at some distance from the office of the client, it would readily be seen that it would be inconvenient, and sometimes impossible, to secure the information needed.

Remember that the Working Sheet as prepared by an auditor is not to be confused with what was formerly known as a six-column statement. The ledger accounts, as set up by you, show a proper summary of all the real and nominal accounts, consequently the Trial Balance prepared by you, as instructed in Transaction No. 11, is the same as will appear in the first two columns of your Working Sheet. The journal entries set up in accordance with the instructions in Transaction No. 12 will naturally be entered in the adjustment columns of the Working Sheet. After this has been done, you are ready to extend all of the accounts into the proper columns, classifying them as either nominal or real accounts. After the Working Sheet is prepared your work in the office of the client is completed.

Transaction No. 14. You are now instructed to prepare a report for your client, the General Manufacturing Company based on your completion of the audit of their books. This report should consist of the following:

Exhibit "A"—Balance Sheet.

Exhibit "B"—Statement of Profit and Loss.

Schedule "B-1"—Statement of Cost of Sales.

Comments.

Certificate.

Transaction No. 15. Your client requests that you prepare closing journal entries to properly close the nominal accounts as at the close of business, Dec. 31, 1920. His bookkeeper will then post the closing entries to the proper ledger accounts.

Appendix

ACCOUNTING TERMINOLOGY

Applicants have been asked to define the following accounting terms in the examinations given in the various states since the first law was passed in New York in 1896 recognizing accountancy as a profession. The definitions presented here are, in part, those prepared by the Committee on Terminology appointed by the American Association of Public Accountants. This Committee was made up of the following members, all of whom are Certified Public Accountants:

J. Lee Nicholson, Chairman
Hamilton S. Corwin,
Henry B. Fernald,
John R. Wildman.

Terms not defined by the above Committee, but which have been used in the examinations are herein defined, and the definitions given are those sanctioned by the best accounting authorities.

Abeyance. Held in suspense for future settlement or adjustment.

Abstract of Postings. A list of ledger postings such as one drawn off for the purpose of proving the postings in the ledger with the books of original entry or for special information.

Acceptance. (1) An agreement to pay a bill of exchange, draft, order or kindred instrument on the terms stated therein. (2) The document itself when bearing on its face the evidence of its acceptance.

Accommodation. A loan of money or endorsement of another person's paper as a favor.

Accommodation Paper. Instruments which a maker, drawer, acceptor or indorser, having no interest in the transaction, signs merely as an accommodation to another.

Account. An entry or group of entries, either debits or credits or a combination of both, under a specific or descriptive heading, exhibiting the history and results of the transactions pertaining thereto.

Account Current. A running record of current financial transactions between two parties who may, through the growth of their account, become debtor or creditor alternately.

Account Sales. A statement giving an accounting of goods sold, rendered by a consignee to the consignor.

Account Receivable. An account showing a debit balance to be presently received in cash or its equivalent.

Account Payable. An account showing a credit balance to be presently paid in cash or its equivalent.

Accountability. That relation which exists between two parties by virtue of which one is required to account to the other for money or property.

Accountancy is a profession having to do with the recording, verification and presentation of facts involving the acquisition, production, conservation and transfer of values.

Accountant. One skilled in the science of accounting.

Accounting. Accounting is the science which treats of the systematic record, compilation and presentation in a comprehensive manner of the financial operations of a business.

Accrual. (1) The act of accruing. (2) That portion of an accruing account not yet due applicable to the accounts of the period under consideration.

Accrue. (1) To accumulate automatically through lapse of time. (2) To set up or record a debit or credit automatically accumulating through lapse of time.

Accrued interest receivable or payable is the amount of accruals of interest on various classes of assets or liabilities.

Accrued taxes is the amount of accruals of taxes.

Accrued dividends (or accumulated dividend) is the amount of accruals of dividends receivable or payable on guaranteed or cumulative stocks owned, issued or guaranteed.

Active Account. An account in which the entries are frequent; as distinguished from an "inactive" account.

Active Partner. A partner who is subject to full partnership liability as distinguished from a "silent" or "special" partner, whose liability is limited.

Additional Capital. New capital; i. e., an amount supplied as capital increasing that previously provided. The term "additional capital" refers to the amount coming into the

business as distinguished from the expenditures made in increasing capital investments. (See Additions to Capital.)

Additions to Capital. (A contraction of "additions to capital investments.") Expenditures for capital account; "capital expenditure." The amounts expended for additional capital assets, such as structures, machinery or permanent equipment.

Adjustment Account. A temporary account set up to show a record of the items of a transaction or series of transactions subject to and pending its clearance by definite classification or by adjustment between the respective interests therein.

Adjustment Mortgage Bonds. Mortgage bonds issued under a modification of the terms of a previous issue, the conditions of which the debtors have been unable to fulfill.

Administration Expenses. Expenses incurred in connection with the administration of a business, usually the salary and expenses of the executives and other expenses not directly chargeable to specific operating or selling expenses.

Administrator. A person named by the probate court, or other proper authority, to take charge of the property and administer the estate of one dying without leaving a will or an estate for which no competent executor is named in the will.

Advance Bill. A commercial "bill of exchange" drawn against goods subsequently to be shipped instead of against a shipment already made.

Advertising Expense. The expense of attracting the attention of the public to a business, product, proposition or fact.

Affiliated Company (or Corporation.) A company (or corporation) related to another through stock or bond ownership, operating agreement or other mutuality of interest.

Agency. (a) The relationship between principal and agent. (b) The place of business of an agent.

Agent. A person duly authorized to act on behalf of another, or one whose unauthorized act has been duly ratified.

Allocate. (a) To assign items to their appropriate captions in a classification of accounts. (b) To classify.

Allonge. A slip of paper attached to a negotiable instrument to receive endorsement for which there is no space on the instrument itself.

Allowance. (1) A concession or abatement. Specifically in accounting usage, a concession made to customers because of faults existing or claimed in goods or service. (2) A definite amount granted or determined upon for a specific purpose; as an allowance for depreciation, an allowance in lieu of actual expenses, etc.

Amortization. The gradual extinguishment of the amount of an asset, liability, profit or loss by pro-rating it over the period during which it will exist or during which its benefit will be realized. Specifically, (1) The gradual extinction of a debt, as, for instance, by means of a sinking fund. (2) The gradual reduction in the valuation of an asset, thus anticipating the time when it shall eventually become worthless; as distinguished from provision for depreciation or replacements because of physical loss or damage. (3) The absorption in the Income or Profit and Loss accounts, during the pendency of the debt, of a discount incurred or of a premium realized in the sale of an obligation, which discount or premium may be carried in the meantime in a debit or in a credit Suspense account.

Annuity. A fixed sum of money granted or bequeathed, payable yearly or at certain regular periods.

Appraisal. The result of a valuation of property or other assets, used mostly in connection with the valuation of fixed assets of a corporation.

Appreciation. Increase in value through improvement in condition or market value, applied in respect of real estate, plant, machinery, securities, etc.

Assigned Accounts. Accounts originally due to one person who has by agreement made them payable to some other person, usually his creditor.

Auditor. An accountant who examines, criticizes and passes upon the accuracy of accounts.

Balance Sheet. A statement showing the financial condition of a business at a specific date.

Balance Sheet Audit. A verification of the assets and liabilities and a sufficiently exhaustive analysis of the Profit and Loss accounts enabling the auditor to certify that the surplus appearing in the Balance Sheet is reasonably correct.

Bank of Discount. A bank authorized by law to lend money on personal notes. The term bank, as used here, means any moneyed corporation authorized by law to issue bills, notes, or other evidences of debt for circulation as money, or to receive deposits of money and commercial paper and to make loans

thereon, and to discount bills, notes, or other commercial paper and to buy and sell gold and silver bullion or foreign coins or bills of exchange. (N. Y. State Banking Law.)

Book Inventory. A record of all goods put into and taken out of stock, and the balance remaining on hand. It always shows quantities and must also show values if the cost records are articulated with the general books.

Budget. A statement of the estimated revenues and expenditures for a given future period.

Capital. This term as used in accounting is employed to express the sum of the net assets, or the sum which remains after deducting the total liabilities from the total assets of a business or undertaking.

Any principal sum (usually in cash, sometimes in property) contributed to an undertaking by a partner or other individual for supplying the means to operate such undertaking.

The value or amount any individual has invested in an undertaking.

Any principal sum which is used or retained to produce income or profit.

Capital Assets. Includes real estate, buildings, and other structures, equipment and other personal property of a more or less permanent character, and cash on hand specifically applicable to these assets.

Capital Expenditures. All sums expended for addition to, or improvement of, properties.

Capital Liabilities. Liabilities incurred in the acquisition of capital assets.

Capital Receipts. Cash received from stockholders in a corporation in payment of their subscriptions to the capital stock.

Capital Stock. The amount of share capital (issued or authorized) of a company or corporation.

Cash. Lawful money. Usually understood to include cash items and such other instruments as are received by banks for deposit.

Cash Disbursements. Cash payments made during a stated period regardless of the purpose of the payment.

Cash Journal. A book of original entry in which both cash and non-cash entries are recorded. Columns are provided for cash receipts, cash payments, and for accounts most frequently debited and credited. Sundry debit and credit columns are also provided.

Cash Receipts. Cash received during a stated period regardless of the purpose for which received.

Chattel Mortgage. A lien upon personal property, given by the owner as security for the payment of a debt or the performance of some other obligation. Upon default, such lien may be perfected into an absolute title by foreclosure and sale.

Closing Entries. Entries made upon the books of account at the end of a fiscal period for the purpose of closing the nominal accounts.

Consignment Accounts. Those accounts which cover the consignment of goods to an agent or consignee.

Consolidated Balance Sheet. A Balance Sheet which exhibits the combined financial condition of a number of business organizations.

Construction Account. An account employed to show the cost of construction of a piece of property. It is usually made to contain all items, such as material, labor, expense, entering in the work; in some cases interest on borrowed money is charged against this account and even the discount on the sale of bonds issued for the work.

Contingent Fund. Money set aside to be drawn upon only in case of certain emergencies.

Contingent Liability. An amount which may become due usually through the default or action of a third party.

Controlling Account. An account kept in the general ledger which represents in one account the sum of all the transactions, and of all the balances of a group of accounts in a subsidiary ledger, or other record such as a voucher payable record.

Costs Incurred. All expenditures, whether paid in cash or not, for which a business has become liable.

Current Assets. Those assets which can be readily converted into cash.

Current Liabilities. Amounts owed subject to constant change, such as accounts payable to creditors, becoming due and payable in short periods.

Deferred Charges to Operations. That part of operating expenditures which is paid within a given period but is not properly a charge against the income of that period and, therefore, is deferred or postponed until a period following.

Deferred Credit. That part of revenue which is received within a certain period, but is not properly a credit to the income for that period, and, therefore, is deferred or postponed until a period following.

Deferred Debit. That part of expenditures which is paid within a certain period, but is not properly a charge against that period and, therefore, is deferred or postponed until a period folfowing.

Deficiency Account. An account relative to a statement of affairs, showing the causes for the prospective deficiency in the payments to the unsecured creditors of an insolvent concern.

Departmental Accounts. A system of accounts which covers the separate workings of the departments of any concern usually in relation to the profit or loss made by such departments.

Depreciation. That inevitable lessening in value, which is inherent in any fixed asset, caused by wear and tear and gradual obsolescence.

Depreciation Fund. Cash or other assets set aside to provide for depreciation of plant, property, etc.

Depreciation Reserve. A part of the earnings set aside and carried as a credit to offset any deterioration of assets which has taken place or is likely to arise.

Diminishing or Wasting Assets. Assets which diminish proportionately to the lapse of time or to their consumption as an element of production.

Disbursements. Cash payments made during stated period, regardless of the purpose of the payment.

Dividend Account. The controlling account in the general ledger of any corporation to which is credited the amount of dividend on the day of declaration and to which are charged checks issued in payment thereof, either "en bloc" or as they may be presented for payment.

Effective Interest Rate. The ratio of the amount earned to the actual amount of money invested, as distinguished from the nominal rate which is figured on the par value of the bond or other investment.

Effective Rate. (See "Effective Interest Rate.")

Financial Statement. A Balance Sheet. Sometimes taken to include all other statements, such as a statement of affairs, a statement of income and expenditures, and a statement of profit and loss.

Finished Product. The article of trade of a manufacturing concern which has been completed and is ready for sale.

Fixed Assets. Such assets as are stationary and may be regarded to a certain extent as permanent, such as real estate, buildings, plant, machinery, etc. The term "Fixed Assets" and "Fixed Capital" are frequently interchanged, but preference is given to the former term.

Fixed Charges. Charges which remain comparatively unchanged during long periods of time, such as interest on bonds, debentures, etc.

Fixed Liabilities. The permanent or ultimate obligations as distinct from the current obligations (or floating indebtedness) of a person, firm, or corporation.

Floating Assets. Same as liquid, sometimes called "Circulating Assets."

Floating Capital. Capital which is not in a fixed or permanent shape, but is available or convertible, such as raw material, book debts, cash, etc.

Floating Debt. (1) That portion of a debt of a corporation or undertaking which is not represented by a bond issue. (2) General or ordinary indebtedness.

Floating Liabilities. Amounts which are due to others or are about to become due, as creditors' accounts and bills payable.

Funded Debt. That portion of a debt which is represented by a bond issue and payable at a distant date.

General Balance Sheet. A Balance Sheet by totals, i. e., one which shows the financial condition of a company by group accounts without regard to detail.

Good Will. Good will represents the value attached to a business over and above the value of the physical property.

Hypothecate. To pledge or mortgage.

Impersonal Accounts. Accounts which represent condition and record the profits, losses, receipts, expenditures, assets, and liabilities, but do not represent persons.

Imprest System. A system for making petty cash disbursements whereby the petty cashier is reimbursed for the exact amount disbursed, the original amount of the petty cash fund remaining unaltered. The reimbursing check is charged to the proper expense accounts for which the petty cash payments have been made.

Income. The account which sets forth the entire income for a fixed period whether actually received or not.

The gain which proceeds from property, from manufacturing and selling, or from buying and selling.

The remuneration derived from skill or labor.

The proceeds of the property of an estate.

Income Bond. A long-term promissory note, the interest on which is payable out of income if earned.

Interest Account. A revenue account to which is debited and credited interest incurred or earned whether paid or not.

Inventory. (1) The annual account of stock of a business. (2) A schedule of assets or property. (3) An itemized list of goods or valuables with prices attached.

Joint Venture Account. An account covering a specific shipment of consigned goods to be sold for the benefit of two or more parties.

Legal Assets. Property which creditors might make available in a court of law for the payment of the debts of a deceased person.

Life Tenant. The beneficiary under a will who enjoys the income from an estate during life.

Liquid Assets. Cash and such assets as can readily be converted into cash.

Loose-Leaf System. A binding device which permits the insertion and removal of sheets as desired. It is not a distinctive system of accounting. Either the books of original entry or the ledgers may be kept in loose-leaf form if desired.

Maintenance Reserves. A reserve to which may be charged expenses in connection with maintaining some asset for which the reserve has been created.

Manufacturing Account. An account subsidiary to the Profit and Loss account for the purpose of showing the result of factory operations as distinguished from trading operations.

Material Account. An account used to control the amount of material on hand in a manufacturing concern. The account is charged with purchases and credited with issues to factory. The balance should agree with the inventory of material.

Merchandise Account. An account intended to represent the trading transactions of a business, and to exhibit gross profit made on same. An account to which is charged the purchases of material to be sold or used in manufacture, and to which may be credited the materials sold or used.

National Bank Notes. Promissory notes issued by national banks and circulating as money. Such notes are fully secured by United States bonds purchased by the issuing bank and deposited in the United States Treasury.

Net Income. After all costs of operation and fixed charges of every kind have been deducted from the earnings of a corporation, the balance, which is the amount available for dividends, may be called "net income".

Net Profit. The balance remaining after all expenses of distribution and establishment charges, discount, interest, etc., have been deducted from the gross profits.

The balance of the Profit and Loss account when the same is a gain.

The surplus remaining over from the employment of capital after defraying all the expenses and outlay incurred in its employment, and after the capital has been replaced or provision made for its replacement.

Nominal Accounts. Accounts which represent income or expenses. Accounts used for the purpose of classifying income and expenses under such heads as rent, taxes, sales, purchases, salaries, etc., forming the material for the construction of the Profit and Loss statement.

Nominal Interest Rate. The rate of interest on bonds figured on the par value of the bond.

Operating Expense. The expense incurred in the regular transactions of a business.

Overhead Expense or Burden. Elements of cost which cannot be definitely assigned to any particular job, or series of jobs, but are a part of the expense of manufacture, and must be taken into account in calculating costs.

Organization Expenses. Expenses which are necessarily incurred before a corporation can begin to do business. They include such things as the legal and other fees for obtaining the charter, the expense of obtaining subscriptions to the stock, and sometimes the comission paid to brokers for selling the stock. Charging discount on stock sold below par to this account is a questionable practice sometimes indulged in.

Pay Roll Advances. Wages paid in advance.

Personal Account. Accounts showing the transactions with persons, as customers' and creditors' accounts.

Plant Accounts. An account the debit balance of which represents the value of land, buildings, and sometimes machinery and fixtures, of a business concern.

Present Worth of Deferred Payment. An amount which if put at interest will at maturity amount to the deferred payment.

Profit and Loss Account. A summary account showing the income and losses during a given period.

Proprietary Interest. The interest of a proprietor or partner. A partner has a proprietary interest in all of the assets of the firm.

Purchases Ledger. A subsidiary ledger containing accounts with creditors—accounts payable—usually controlled by an account in the general ledger.

Qualified Certificate. A certificate that does not state positive facts as the results of an audit, but contains some clause or expression which is intended to limit the responsibility of the auditor in regard to some one or more items, the accuracy of which he has not been able to verify.

Real Account. Represents the value of an actual asset, or the amount of an actual liability, such as real estate, machinery, loans, and mortgages.

Realization and Liquidation Account. An account showing the result of the liquidation of a business or estate.

Redemption Fund. A fund accumulated for the payment of redeemable debentures, funded debt, or other obligations.

Remainderman. The beneficiary under a will to whom the estate passes at the death of an intermediate party, called the life-tenant, who enjoys the income from said estate throughout life.

Reserve Fund. Cash set aside out of the general funds, usually measured by a reserve (credit), both the fund and the reserve being created for some specific purpose. The reserve (credit) represents the profits withheld, while the fund shows the amount of cash available for the specific purpose.

Revenue Account. An account which relates to profits and losses, income and expenditures, as distinguished from capital accounts which relate to assets and liabilities.

Revenue Accrued. That which has been earned since the last receipt of revenue but is not due and has not been received.

Revenue Balance Sheet. In municipal accounting, a Balance Sheet of current assets and liabilities, showing cash and amounts due from current revenues and the liability thereon due to appropriations.

Revenue Expenditures. Expenditures made in connection with the running expenses of the legitimate business of the firm or corporation concerned. Expenditures that only have the effect of putting the earning power of the undertaking upon the same footing as that which had previously obtained, must be charged against revenue.

Revenue Receipts. They are distinguished from capital receipts by being exclusively derived from the sale or exchange of the commodities which the company was organized to buy and sell, the excess of receipts over expenditures constituting net profit or added actual capital. Receipts derived as the direct result of trading, as distinguished from capital receipts resulting from the sale of capital stock, or proceeds of bonds, mortgages, etc.

Secret Reserves. Values of assets in excess of those indicated by the Balance Sheet.

Serial Bonds. An issue of bonds payable in instalments.

Shipment Account. Corresponds to "Adventure Account," but is the account on the books of the consignee.

Single Name Paper. A note for which a single individual, firm, or corporation is responsible for payment; a note bearing but one signature and without endorsers.

Sinking Fund. A certain sum set aside each year, that accumulated at compound interest, will be sufficient to provide for the payment of bonds or other obligations maturing at some future time.

Statement of Affairs. An exhibit of the assets and the liabilities of an insolvent debtor, so arranged as to show on one side all the assets of the concern with the amounts they are expected to realize extended into another column, and on the other side all the concern's gross liabilities with the amount expected to rank carried into a separate column.

Statement of Assets and Liabilities. A statement of financial condition of a solvent concern, where the books are kept by single entry, is best designated as a "Statement of Assets and Liabilities."

Statement of Income and Expense. A statement which shows the income earned and expenses incurred during a certain period, it being immaterial whether or not the items are actually received or disbursed during that period.

Statement of Receipts and Disbursements. A statement arranged in report form, showing respectively with regard to cash, the balance at the beginning of a period, the classified receipts and disbursements during the period, and the balance remaining at the end of the period.

A summarized Cash account, stating the amounts of money actually received and disbursed during the period to which it relates, without regard to whether the same are earnings or expenses exclusively appertaining to that period, or include items so appertaining to the period preceding. It starts with the cash balance at the commencement of the period which it covers, and concludes with the cash balance at the close thereof.

Summary Account. An account into which a number of detail accounts are closed for the purpose of showing a general result.

Surplus. The excess of assets over liabilities including capital stock. It is in reality undistributed profit.

Surplus Fund. A credit account formed by periodically setting aside a portion of the net profits of a corporation to provide an unspecified reserve for contingencies. In the National Banking Act, a fund created by setting aside one-tenth of the net profits until 20% of the capital has been so reserved for dividends.

Trading Account. This account shows the same facts as the trading accounts on the Profit and Loss statement, and may be shown as a separate account, or as one section of the Profit and Loss account. All accounts relating to the purchase and sale of merchandise are usually classed as trading accounts.

Treasury Stock. Such portion of the capital stock of a corporation as has been fully paid for and legally issued and has since been acquired by the issuing corporation, either by purchase or by donation.

Trial Balance. A Trial Balance is a list of the balances or footings shown on a ledger, for the purpose of testing their accuracy. When successfully compiled, it ceases to be a trial balance and becomes a statement of ledger balances.

Two Name Paper. A note made by two persons as individuals or made by one and endorsed by another—these two persons being severally liable.

Undivided Profits. Earnings or profits which have not been divided among the partners in a firm or the stockholders in a corporation.

Voucher Check. A check which contains as part of the instrument a statement of the account covered by the check. It is used in connection with the voucher system of accounting for expenditures.

Voucher System. A method of accounting for expenditures. The vouchers payable book shows the existing liabilities and serves in the place of a subsidiary accounts payable ledger. A controlling account is kept in the general ledger with Vouchers Payable. This account shows the total of unpaid vouchers.

Will. A last will and testament and all codicils. A solemn declaration in legal form making a disposition of property to take effect at death, but revocable during life by the person making the will.

Working Capital. All assets available for the carrying on of a business, such as cash, accounts receivable, notes receivable, and inventories. Those assets which are the subject of the company's business or may be easily converted into cash.

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